539/985

Department of the Treasury
Internal Revenue Service

Publication 539
(Rev. Nov. 85)

Employment Taxes

- Employees Defined
- Income Tax Withholding
- Social Security Taxes (FICA)
- Federal Unemployment Tax (FUTA)
- Reporting and Allocating Tips

Note: This publication no longer contains a section on information returns for payments made to nonemployees. This information is in new Publication 916, *Information Returns.*

For use in preparing **1985 Returns**

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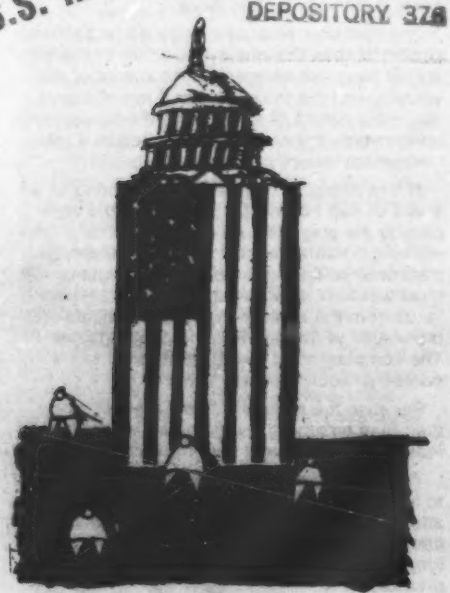

Introduction

If you have any employees, you will probably be required to withhold federal income tax from their wages. You may also have to pay social security (FICA) taxes and federal unemployment (FUTA) tax. This publication discusses an employer's responsibility for these taxes. It also discusses income tax withholding on other payments and the rules for advance payment of the earned income credit.

If you need information on railroad retirement taxes, see the instructions for Form CT–1, *Employer's Annual Railroad Retirement Tax Return,* and Form CT–2, *Employee Representative's Quarterly Railroad Retirement Tax Return.*

Who Are Employees?

Before you can know how to treat payments you make for services rendered to you, you must first know the business relationship that exists between you and the person performing those services. This relationship may be that of:

1) An independent contractor;
2) A common-law employee; or
3) A statutory employee.

This section will explain these three relationships. It will also give examples from various types of occupations.

Independent contractors. People such as lawyers, contractors, subcontractors, public stenographers, auctioneers, etc., who follow an independent trade, business, or profession in which they offer their services to the general public, are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case. The general rule of thumb is that an individual is an independent contractor if you, the employer, have the right to control or direct only the result of the work and not the means and methods of accomplishing the result.

Two categories of ***statutory nonemployees*** have been established: direct sellers and real estate agents. They are treated as self-employed if certain conditions are met. See *Direct Sellers and Real Estate Agents* later.

Common-law employees. Under common-law rules, every individual who performs services that are subject to the will and control of an employer, as to both ***what*** must be done and ***how*** it must be done, is an employee. It does not matter that the employer allows the employee considerable discretion and freedom of action, so long as the employer has the ***legal right*** to control both the method and the result of the services.

Two of the usual characteristics of an employer-employee relationship are that the employer has the right to discharge the employee and the employer supplies the employee with tools and a place to work.

If you have an employer-employee relationship, it makes no difference how it is described. Thus, it does not matter if the employee is called an employee, or a partner, coadventurer, agent, or independent contractor. It does not matter how the payments are measured, how they are made, or what they are called. Nor does it matter whether the individual is employed full time or part time.

No distinction is made between classes of employees. Superintendents, managers, and other supervisory personnel are all employees. Generally, an officer of a corporation is an employee, but a director is not. However, an officer who performs no services or only minor services, and neither receives nor is entitled to receive any pay, is not considered to be an employee.

In doubtful cases, the facts will determine whether or not there is an actual employer-employee relationship. If you want the Internal Revenue Service to determine whether a worker is an employee, file Form SS–8 with the District Director.

Relief provisions. If you have a reasonable basis for treating a worker other than as an employee, you are not liable for employment taxes on the payments to that worker. To get this relief, you must file all required federal tax returns, including information returns, on a basis consistent with your treatment of the worker. You (or your predecessor) must not have treated any worker holding a substantially similar position as an employee for any periods beginning after 1977. For further information, see Revenue Procedure 85–18. It is published in Internal Revenue Bulletin 1985–13, page 27.

Statutory employee. If an individual who works for you is not an employee under the common-law rules, you do not have to withhold federal income tax from that individual's pay. However, for social security taxes, the term ***employee*** may mean any individual who works for you for pay in one of the following four categories.

1) A driver who distributes meat products, vegetable products, fruit products, bakery products, or beverages (other than milk) or picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
2) A full-time life insurance sales agent.
3) An individual who works at home on materials or goods which you supply and which must be returned to you or to a person you name, if you also furnish specifications for the work to be done.
4) A full-time traveling or city salesperson who works on your behalf and turns in orders to you from wholesalers, retailers, contractors or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation.

Individuals within any of these categories are employees for social security tax purposes if:

a) The service contract states or implies that almost all of the services are to be performed personally by them;
b) The investment in the facilities (other than in facilities for transportation) used to perform the services is not substantially the individual's; and
c) The services are performed on a continuing basis.

For federal unemployment tax purposes, the term ***employee*** means the same as it does for social security tax purposes, except that it does not include (2) and (3), above. Thus, any individual who is an employee under (1) or (4) is also an employee for federal unemployment tax purposes.

General rule. You may find it helpful to remember the following general rules for withholding.

1) ***Independent contractors.*** You do not have to withhold income tax or social security tax from amounts you pay an independent contractor. But, if you pay an independent contractor $600 or more during the year in the course of your trade or business, you must file a Form 1099–MISC, *Statement for Recipients of Miscellaneous Income,* with your Internal Revenue Service Center.
2) ***Common-law employees.*** You may have to withhold income tax and social security tax from the wages you pay common-law employees. Also, you may have to pay federal

unemployment tax and your share of social security taxes on these wages.

3) ***Statutory employees.*** You do not have to withhold income tax from the wages of statutory employees. But you must withhold and pay social security taxes. Unless they are full-time life insurance sales agents or work at home, you must also pay federal unemployment tax on their wages.

Additional information. For more information about the employer-employee relationship, what wages are taxable, the treatment of special types of employment and special types of payments, and similar subjects, get a free copy of Publication 15, *Circular E, Employer's Tax Guide,* from the Internal Revenue Service. If you hire agricultural labor, you should get a copy of Publication 51, *Circular A, Agricultural Employer's Tax Guide.*

Building and Construction Industry

Example 1. John Brown has an oral agreement with Ace Building Co. to do carpentry work on any house designated by the Ace Co. John supplies his own hand tools. The Ace Co. supplies the material for each job. John has to do the work himself, and he works on a full-time basis for the company. For some work he is paid on a piecework basis and for some on an hourly basis. John has no assistants, does not have an office, and does not advertise in newspapers or otherwise hold himself out to the public as being in the carpentry business. He can be discharged by the Ace Co. any time before he finishes a job, without contractual liability. John is an employee of the Ace Co.

Example 2. Ron Smith, a mason, has an oral agreement with Jiffy, Inc., a contractor, to face a building with brick. All material for the job is supplied by Jiffy. Mr. Smith supplies only his hand tools. He has to do the work himself, and he is paid on an hourly basis. Two other masons on the job, who are supervised by Mr. Smith, are employed by Jiffy. Detailed supervision over Mr. Smith is neither necessary nor warranted because of his skill in the work. He can quit the job at any time, or he can be discharged by Jiffy at any time. He has no investment or proprietary interest in a business that offers to the general public services similar to those he is doing for Jiffy. Mr. Smith is an employee of Jiffy, Inc.

Example 3. Tom Green is a painting subcontractor who has contracted to paint 264 houses. He hired 40 painters to do the work for him, although only about 15 are on the job at any one time. Mr. Green supplies all the paint, brushes, and ladders. He designates the house to be painted and sometimes pays the painters so much per house and other times by the hour. Detailed instructions about the work are not necessary because of the painters' skill in their trade. The work is inspected, and Mr. Green requires them to repaint any unsatisfactory work. The painters cannot engage helpers without his consent. Mr. Green can discharge them for any reason, and they are free to resign at any time. The painters are under no legal obligation to complete the painting of the houses. They assumed no business risks and have no capital investment. None of them has an established business. The painters are employees of Mr. Green.

Example 4. Wilma White has an agreement with Jerry Jones under which he is supervising the remodeling of her house. She did not advance him funds to help him carry on the work. She makes direct payments to the suppliers for all the necessary materials. She carries liability and worker's compensation insurance covering Jerry and others he engaged to assist him; she pays them on an hourly basis, and she exercises almost constant supervision over the work. Jerry is not free to transfer his assistants to other jobs and he may not work on other jobs while working for Wilma. Jerry assumed no responsibility for the completion of the work and will incur no contractual liability if he fails to complete the job. Jerry and his assistants are performing personal services for hourly wages. They are employees of Wilma White.

Example 5. Milton Manning, an experienced tilesetter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs the services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of his work, pays him on a piecework basis, and carries worker's compensation insurance on him. He does not have a place of business or hold himself out to perform similar services for others. The services can be ended by either party at any time. Mr. Manning is an employee of the corporation.

Example 6. Wallace Black agreed with the Sawdust Co. to supply the labor needed for the construction of a group of houses. The Sawdust Co. agreed to pay all the costs of construction. However, Mr. Black supplies all the tools and equipment. He performs personal services as a carpenter and mechanic, for which he is paid an hourly wage. He also acts as superintendent and foreman, and engages other individuals to assist him. The Sawdust Co. has the right to select, approve, or discharge any helper. A company representative makes frequent inspections of the construction site. When a house is finished, Mr. Black is paid a certain percentage of its costs. He is not responsible for faults or defects of construction or for wasteful operation. At the end of each week he presents to the Sawdust Co. a statement of the amount he has spent, including the payroll. The Company gives Mr. Black a check for the amount out of which he pays the assistants, although he is not personally liable for their wages. Mr. Black and his assistants are employees of the Sawdust Co.

Example 7. A local plumbers' union and a contractors' association agreed to set up an apprenticeship program. The program is financed by the contractors and is administered by a joint apprenticeship committee. Trainees are enrolled first in a preapprenticeship program, in which they attend vocational school full time 5 days a week for 6 to 8 weeks. During this period, the trainees are paid an hourly rate and are furnished with all materials and supplies used in school.

After completion of the pretraining period, the trainees are assigned to work for local contractors as apprentice plumbers. The apprentices have to attend training classes related to the trade one day a week over a period of 2 years. They are paid by the apprenticeship program for the time spent in attending classes at the same hourly rate that they earn working for their contractor-employers.

Under these circumstances, the ***preapprenticeship trainees*** are not employees and their payments from the program are not subject to income tax withholding or social security taxes, and the contractors and the administrators of the preapprenticeship program are not liable for federal unemployment tax. However, the apprentices who are assigned to contractors are considered employees, even when attending classes under the apprenticeship program. The payments by the program to the apprentices are subject to income tax withholding, social security taxes, and federal unemployment tax.

Trucking Business

Example 1. Drivers for Rover Trucking Co. often engage laborers to unload their trucks. This is done with the express consent of Rover Co. The unloaders are paid by the drivers from funds provided by Rover Co. The unloaders are employees of Rover Co. This also would be true if the drivers had only the implied consent of Rover Co.

Example 2. Phil Blue is engaged by a company to haul products to its customers. The company has legal ownership and control of the trucking equipment. It has preferred call on Phil's services and he can be required, upon an hour's notice, to make deliveries at times and places specified by the company. Refusal to make deliveries can jeopardize his relationship with the company. He has to operate and maintain the equipment and provide the necessary operators and helpers. He is not allowed to use the company's equipment to haul for others. Phil is paid on a tonnage basis and is not guaranteed a minimum amount of compensation. He has to pay the operators and helpers out of his tonnage receipts as well as pay for all insurance coverage required by the company. Phil and any operators or helpers engaged to assist him are employees of the company.

Fishing Industry

Example. Mr. Harry Rose is the captain of one of the Pan Fishing Company's fishing schooners. Captain Rose in turn engages a crew of 15 to operate the vessel. He offers to pay each crew member on the ***lay*** (sharing of the profit) basis. He and the members of his crew (except the engineer, who is paid a straight fee) are jointly liable for any losses resulting from a voyage.

The schooner is an American vessel of more than 10 net tons. The contract of service was entered into within the United States.

After the voyage, Captain Rose sells the catch through a fish exchange, which deducts its fees from the proceeds. Then, after deducting certain specified expenses (such as fuel, oil, lights, etc.) he turns one-fourth of the proceeds over to Pan Fishing Co., less 5%, which he keeps as his commission. From the remaining three-fourths, the expenses of food, bait, etc. are deducted. The remainder is then equally divided among the members of the crew, including Captain Rose.

The members of a crew engaged under these circumstances are employees either of the captain (if he is not an agent of the owner of the vessel) or of the vessel owner. Lays of crews are in the nature of wages, and the agreements under which the crews are engaged in these circumstances are contracts of hire.

In this example, Captain Rose is acting as an agent of Pan Fishing Co.; therefore, the company is the employer. As an employer of a crew working on an American vessel under a contract entered into in the U.S., the company must withhold income tax and social security taxes from the entire crew's wages, including the wages of Captain Rose and the engineer. The company must also pay the employer's portion of social security taxes.

Because the schooner has a crew of more than nine members, the company must also pay federal unemployment tax on these wages.

The value of ***meals and lodging*** is not subject to income tax withholding, social security taxes, and federal unemployment tax because the company must furnish meals and lodging to the employees on board the vessel so that they can do their work.

Federal unemployment tax. Generally, the work of catching fish is exempt from federal unemployment tax *except* for:

1) Work related to catching salmon or halibut for commercial purposes; or
2) Work performed on or in connection with a vessel of more than 10 net tons.

Certain crew members considered self-employed. Wages paid to the members of a crew on a boat that is engaged in the catching of fish or other forms of aquatic animal life are not subject to federal income tax withholding and social security taxes if:

1) The members do not get and are not entitled to get any money for their work (other than as provided in condition (2), below);
2) The members get shares of the catch or shares of the proceeds from the sale of the catch;
3) Each member's share depends on the size of the catch; and
4) The operating crew of the boat (or each boat from which a member gets a share for a fishing operation involving more than one boat) normally numbers less than 10.

Each member of the crew that meets these conditions is considered self-employed and not an employee for purposes of social security taxes and federal income tax withholding. The earnings of these crew members are considered trade or business income and therefore subject to self-employment tax. See Publication 533, *Self-Employment Tax*.

Example 1. Mike Jones, an owner of a fishing boat, employs a captain and eight others to work as the crew members on the boat. The proceeds from the sale of the catch first offset boat operating expenses such as fuel, bait, and ice, and then the balance of the proceeds are divided 60% among the captain and the crew members and 40% between Mike and the captain. Between voyages the crew members do not receive any additional compensation, but they must do certain work, such as repairing nets, splicing cable, and transporting the catch. However, the mate, the engineer, and the cook receive an additional payment of $25 each. The payment does not depend upon the boat's catch. Since the mate, the engineer, and the cook receive payment other than a share of the catch, they are not considered self-employed. The $25 payment and their share of the proceeds from the catch are subject to federal income tax withholding and social security taxes.

However, the other six crew members, including the captain, are considered self-employed because they do not receive any additional pay and are members of an operating crew of fewer than 10 members. Mike does not have to withhold federal income tax or social security taxes from their pay. They must pay self-employment tax on their earnings.

Example 2. Assume the same facts as in Example 1, except that, in addition to receiving a share of the catch, the captain and the other crew members are entitled to receive $3 per hour for repairing nets, constructing new nets, splicing cable, and other incidental work while in port. Since the crew members are entitled to receive payment other than a share of the catch, they are not considered self-employed. The $3 per hour payment and their share of the proceeds from the catch are subject to federal income tax withholding and social security taxes.

Reporting requirements. The operator of a boat must file with the Internal Revenue Service a completed Form 1099–MISC, *Statement for Recipients of Miscellaneous Income*, if any of the crew members work as self-employed individuals. It must be filed with the Internal Revenue Service by February 28 following the calendar year in which the crew member was paid.

Statement to crewmen. Every operator who is required to file Form 1099–MISC must also furnish a statement to each crew member. You may use Copy B of Form 1099–MISC for this purpose. This statement must be furnished to all crew members by January 31 of the year following the calendar year in which the crew member was paid.

Unemployment tax. Self-employed crew members do not pay federal unemployment tax on their earnings. However, the operator of the boat may still be subject to federal unemployment tax on the earnings of these crew members if the services they perform come under the exceptions stated earlier under *Federal unemployment tax*.

Non-American vessels. If you have questions concerning employment on non-American vessels, write to the Internal Revenue Service.

Shrimp Processing

Example. Shirley Gray is engaged by the Capital Shrimp Processing Co. to devein shrimp. She works on a seasonal, part-time basis on the company's premises. Shirley is paid on a piecework basis. Her services can be ended by either herself or the company at any time. The percentage of her time spent in working for the Capital Shrimp Processing Co. varies. She also deveins shrimp under similar circumstances for other processing firms. Shirley is an employee of the Capital Shrimp Processing Co.

Dentistry

Example 1. James Jones, a dental hygienist, is engaged by Dr. Jean Red, a dentist, to give oral prophylaxis treatment to her patients at her office on designated days of each week. His agreement with her states that he will receive 50% of the fee charged each patient treated, whether or not it is collected from the patient. The laws of the state where the services are performed states that a registered dental hygienist may operate only under the general direction or supervision of a licensed dentist in the dentist's office or in any public school or other institution giving dental services. Therefore, the dental hygienist is an employee of the dentist.

Example 2. Dr. James White, a dentist, entered into a verbal agreement with Dr. Henry Green under which Dr. Green agreed to perform dental services in Dr. White's office. Dr. Green agreed to work for a salary plus a percentage of all income over a stated amount resulting from his services. He has to observe designated office hours and to obtain Dr. White's approval for any absences. Dr. White supplies all instruments and pays all of the office expenses, and he alone realizes all losses from unpaid accounts. He also employs the nurse who assists Dr. Green. Either party can end this agreement at any time. Dr. Green is an employee of Dr. White.

Automobile Industry

Example 1. Donna Lee is a salesperson employed to work on a full-time basis by Bob Blue, an auto dealer. She works 6 days a week and is on duty in Bob's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager's approval. Lists of prospective customers are the property of the dealer. Donna has to develop leads and to report the results to the sales manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Donna is an employee of Bob Blue.

Example 2. Sam Sparks performs automobile repair services in the repair department of an automobile sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies all facilities, repair parts, and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completion of each job; and checks all estimates and repair orders. Sam is an employee of the sales company.

Example 3. Helen Smith performs automobile repair services in space furnished by an auto sales agency. She supplies her own tools, equipment, and supplies, and she seeks out business from insurance adjusters and other individuals in addition to doing all the body and paint work that comes to the agency. Helen hires and discharges her own helpers, determines her own and her helpers' working hours, quotes prices for repair work, makes all necessary adjustments, assumes all losses from uncollectible accounts, and receives, as compensation for her services, a large percentage of the gross collections from the auto repair shop. Helen is self-employed and the helpers are her employees.

Motel–Trailer Court

Example 1. The Hometown Corporation engaged Mr. and Mrs. James Smith to manage a motel it owns. They receive a specified amount per week for their services. They have to furnish services 24 hours daily. The services include registering guests, collecting rent, maintaining rooms in good condition, making minor repairs, etc. Hometown Corporation provides all furnishings, equipment, and office supplies. No part of the operating cost is borne by the managing couple. Major maintenance and repair work has to be authorized by the Hometown Corporation before it can be done. The corporation establishes guest service charges and operating policies and frequently gives instructions that it considers will improve operating conditions. An officer of the corporation inspects the premises three or four times a week to assure its proper care and operation. The managers are employees of the Hometown Corporation.

Example 2. The Atlas Corporation operates a trailer court that is managed by George Brown, a real estate operator. Bill Grape was engaged to service the grounds. He reports to the trailer court every morning, observes regular working hours, follows a daily routine, and supplies whatever equipment is necessary to keep up the appearance of the trailer court. He performs services on a full-time basis and is paid semimonthly. He does not perform services for others, has no business establishment, and does not advertise in newspapers or have a business telephone listing. His services can be ended at any time by either party. Bill is an employee of the Atlas Corporation because the corporation has the right to control him through George, the manager of the trailer court.

Barber Shops and Beauty Salons

Example 1. Paul Pick, a barber, signed a so-called lease agreement with Larry Lord, the owner of a barber shop, for use of a chair in Larry's shop. Larry bears all the expenses of the shop, including rental, utilities, advertising, linens, and other supplies.

The agreement provideds that 70% of the receipts from Paul's chair go to him and 30% go to Larry. All receipts are put in Larry's cash register, and at the end of the week he pays Paul the agreed percentage of the receipts.

The shop's hours are displayed on the door of the shop and Paul is expected to comply with them. Paul has to take customers in turn, maintain clean premises, use clean towels and sterile equipment, and keep a clean personal appearance. Although there is little or no supervision over him, he can be dismissed by Larry for acting in a manner that would cause the loss of patrons, or for any other reason.

Larry does not direct or control Paul in the actual performance of his services, but he has the right to do so, and to discharge him for cause. Larry's income is dependent upon a percentage of Paul's receipts. Thus, Larry retains the right to direct and control him to the extent necessary to protect his investment and to be assured a sufficient return of income from operation of the shop. Paul has no investment in the shop, assumes no liability in connection with its operation, and furnishes nothing except his personal services. Paul is an employee of Larry.

Example 2. Beauty Salons, Inc. leases space for the operation of beauty shops in department stores. Each department store pays the wages of the shop manager and operators employed on the basis of payrolls prepared by the manager. The lessor receives a fixed percentage of shop receipts as rent. Although a department store can compel the removal of an operator or manager from a particular store, Beauty Salons, Inc. controls the hiring, training, transfer, and dismissal of all beauty shop personnel. The managers and operators employed in the shop are considered employees of Beauty Salons, Inc.

Example 3. Charlie Green, the owner of a barber shop, entered into an agreement under which Sally Gold, a professional manicurist, furnishes manicuring services to the shop patrons during business hours.

According to the agreement, Sally regulates her own hours, furnishes her own equipment and supplies, and keeps the proceeds from her work. She does not use the shop cash register nor does she report her earnings to Charlie. Sally does not have to perform her services personally; she could hire a substitute to take her place. Charlie cannot direct the way she performs her services. Either party to the agreement can end the arrangement at any time.

Although Charlie has the right to dismiss Sally by ending the agreement, and although he furnishes her a place to work, he does not have the right to exercise over her work the degree of direction and control necessary to establish an employer-employee relationship. Therefore, Sally is self-employed.

Dry Cleaning

Example 1. Alfred East entered into a written agreement with Spotless Cleaners to collect garments regularly on a designated route and deliver them to Spotless for cleaning and pressing. Alfred is also to solicit customers for Spotless and collect accounts. Spotless specifies the price to be charged to customers, supplies the truck, and bears all of the operating expenses. Alfred is paid a percentage of the money collected for garments he brings in and delivers. Either party can end the contract on 15 days written notice. However, Spotless can discharge Alfred at any time for a violation of its rules, insubordination, being unavailable to customers, failure to account properly for money, or other unsatisfactory route work. Alfred is an employee of Spotless Cleaners.

Example 2. Roger Hemp owns a dry cleaning store. He entered into an agreement with John Brill and Fred Dant under which they will run the business for 3 years for one-half of the net profit. John and Fred agreed to keep the store open during regular business hours, pay the bills from the gross receipts, use Roger's bookkeeping system, employ a bookkeeper approved by him, keep accurate books, keep the store equipment in good condition, and try to hold and increase his business. Roger can end the agreement by giving 10 days written notice. John and Fred have no investment in the store and furnish only their personal services. John, Fred, and the bookkeeper are employees of Roger.

Concessionaires and Caterers

Example 1. Snakko Corporation operates a food concession at a ball park. In addition to its regular staff, it hires school age boys and girls to work at its lunch counters and as vendors. These individuals are engaged for each game, work on a commission basis, and are paid daily. The boys and girls are employees of Snakko Corporation.

Example 2. Elmer, after working in Golda's restaurant for a salary, entered into an agreement with her under which he will operate the business for 50% of the net profits. The arrangement between the parties otherwise remains unchanged. Elmer is required to keep the restaurant open during regular business hours. All supplies are purchased in Golda's name and the parties consult frequently on management problems. Golda makes all final decisions concerning the business. Elmer made no capital investment and has no ownership interest in the business. All licenses are issued to Golda and she remains the owner of record of the real estate and the business. Elmer is an employee of Golda.

Example 3. A caterer contracted to render a customer complete service, including the furnishing of waiters. Services rendered by the waiters are necessary to the operation of the caterer's business, and the caterer exercises over the waiters the control necessary to insure the satisfactory performance of the catering service. The waiters are employees of the caterer.

Salespersons

To determine whether salespersons are employees under the usual common-law rules, it is necessary to evaluate each individual case.

Not an employee. Salespersons generally are not employees under common-law rules if they meet all four of the following tests.

1) They depend almost entirely on their own initiative, efforts, skill, and personality to retain old customers, develop new ones, and achieve a successful volume of sales.
2) They set their own working hours.
3) They pay their own expenses and are not reimbursed by the person or company they represent.
4) They are paid solely on a commission basis and their pay is derived from the results of their work. They are not guaranteed any minimum pay.

Social security (FICA) taxes and federal unemployment (FUTA) tax. Even if a salesperson is not an employee under the usual common-law rules, his or her pay may still be subject to social security and federal unemployment taxes. To determine whether a salesperson is an employee for social security and federal unemployment purposes, it is necessary to apply the statutory employee tests. A salesperson is considered an employee for social security and federal unemployment purposes if he or she:

1) Works full time for one person or company, except, possibly, for sideline sales activities on behalf of some other person;
2) Sells on behalf of, and turns his or her orders over to, the person or company he or she works for;
3) Sells to wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments;
4) Sells merchandise for resale or supplies for use in the customer's business;
5) Agrees to do most of this work personally;
6) Has no substantial investment in the facilities used to do the work, other than in facilities for transportation; and
7) Maintains a continuing relationship with the person or company he or she works for.

Direct Sellers and Real Estate Agents

Direct sellers and licensed real estate agents are treated for federal income tax and employment tax purposes as self-employed if:

1) Substantially all remuneration for their services as direct sellers or real estate agents is directly related to sales or other output, rather than to the number of hours worked, and
2) Their services are performed under a written contract providing that they will not be treated as employees for federal tax purposes.

Direct sellers are persons:

1) Engaged in selling (or soliciting for sale of) consumer products, or
2) Engaged in selling (or soliciting for sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis prescribed by regulations, for resale,

in the home or otherwise than in a permanent retail establishment.

Direct selling includes activities of individuals who attempt to increase direct sales activities of their direct sellers and who realize remuneration dependent on the productivity of their direct sellers. Such activities include providing motivation and encouragement, imparting skills, knowledge, or experience, and recruiting.

For more information on direct sellers, see Publication 911, *Tax Information for Direct Sellers.*

Licensed real estate agents include individuals engaged in appraisal activities in connection with real estate sales if they realize remuneration dependent on sales or other output.

Household Services

If you file Form 941, *Employer's Quarterly Federal Tax Return,* for business employees, you may report wages you pay your household employees with wages you pay your other employees. Otherwise, report these wages on Form 942, *Employer's Quarterly Tax Return for Household Employees.* Household employees are persons you hire to perform services in and about your private home. See *Circular E* for further information, including reporting requirements. If your home is on a farm operated for a profit, also see *Circular A.*

Part–Time Workers

For income tax withholding, social security, and federal unemployment purposes, there is no basic difference between full-time and part-time employees. You must figure the social security and federal unemployment taxes for part-time workers or workers hired for short periods the same way as for full-time workers. It does not matter whether the worker has another job or is having the maximum amount of social security tax withheld by another employer. Income tax withholding may be figured the same way as for full-time workers, or it may be figured by the part-year employment method, explained later in this publication.

Family Members

For social security and federal unemployment tax purposes, the services of a child under the age of 21 who works for his or her parent are not covered, nor are the services of an individual who works for his or her spouse. This is true even if the child or the individual is paid regular wages. Their wages are not subject to social security and federal unemployment taxes. But their wages may still be subject to income tax withholding.

However, the services of a child or a married individual are covered if he or she works for:

1) A corporation even if it is controlled by the child's parent or the individual's spouse;
2) A partnership, even if the child's parent is a partner, unless each partner is a parent of the child;
3) A partnership, even if the individual's spouse is a partner; or
4) An estate, even if it is the estate of a deceased parent.

Under these conditions, a child is not considered to work for his or her parent, and a married individual is not considered to work for his or her spouse. However, note the exception in condition (2) when each partner is a parent.

Companion Sitting Services

A person engaged in the trade or business of referring sitters to individuals who wish to employ them is not considered the employer of the sitters if:

1) He or she does not pay or receive the salary or wages of the sitters; and
2) He or she is paid a fee by the sitter or the persons who employ the sitter.

A sitter is any individual who furnishes personal attendance, companionship, or household care services to children or to individuals who are elderly or disabled.

Example. John Jones operates a placement service for companion sitters. He put Sharon Silver in touch with Mrs. Smith, an elderly lady who was in need of a person to furnish personal attendance, companionship, and household care. Sharon receives her salary directly from Mrs. Smith. Mr. Jones charged Mrs. Smith a fee of $40 for locating a sitter. Sharon is not an employee of Mr. Jones.

Exempt Organizations

Many ***nonprofit organizations*** are exempt from income tax. Although they do not have to pay income tax themselves, they must still withhold income tax from the pay of their employees. However, there are special social security and federal unemployment tax rules that apply to the wages they pay their employees.

Section 501(c)(3) organizations. Nonprofit organizations that are described in section 501(c)(3) of the Internal Revenue Code include any community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. The organizations are usually corporations and are granted exemption from income tax under section 501(a).

Social security taxes. Wages paid to employees of a section 501(c)(3) organization for service performed before January 1, 1984, are not subject to social security taxes, unless the organization chose to waive its exemption from these taxes. If the organization waived its exemption, the wages of an employee paid less than $100 in a calendar year are not subject to social security taxes.

Services performed after 1983. The exemption from social security taxes for nonprofit organizations applies after 1983 only to certain churches and qualified church-controlled organizations that choose the exemption by making an election as explained below. Other section 501(c)(3) organizations are now subject to social security taxes just like other employers.

However, after 1983, two exemptions from social security taxes continue to apply.

1) If a 501(c)(3) organization pays an employee wages of less than $100 in a calendar year, those wages are not subject to social security taxes.
2) If a 501(c)(3) organization is an instrumentality wholly owned by a state or its political subdivision, it is not subject to social security taxes. Such an organization should contact the appropriate state official for information about reporting and getting social security coverage for its employees.

After 1983, a church or church-controlled organization that is opposed for religious reasons to the payment of social security taxes may file Form 8274 to elect exemption from social security taxes. The organization must file for exemption prior to the first date on which a quarterly employment tax return would otherwise be due. (An employee of a church or qualified church-controlled organization that is exempt from social security taxes must pay the self-employment tax if the employee is paid $100 or more in a year.)

Federal unemployment tax. An organization that is exempt from income tax because it is an organization described in Section 501(c)(3) is also exempt from the federal unemployment tax. This exemption cannot be waived.

Other than section 501(c)(3) organizations. Nonprofit organizations that are not section 501(c)(3) organizations also may be exempt from paying income tax under section 501(a) or 521. These organizations are not exempt from income tax withholding or social security or federal unemployment taxes. However, two special rules for social security and federal unemployment taxes apply to these organizations.

1) If an employee is paid less than $100 during a calendar year, his or her wages are not subject to social security taxes.
2) If an employee is paid less than $50 in a calendar quarter, his or her wages are not subject to federal unemployment tax for the quarter.

These rules do not apply to employees who work for pension plans and other similar organizations described in section 401(a).

Income Tax Withholding

Generally, you must withhold income tax from wages you pay employees if their wages for any payroll period are more than the amount of their withholding allowances for that period. The amount to be withheld is figured separately for each payroll period.

A ***payroll period*** is the period of time for which you usually make a payment of wages to an employee. ***Regular*** payroll periods can be daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannually, and annually. A ***miscellaneous*** payroll period is any other period. Sundays and holidays are included in computing the number of days in a miscellaneous payroll period.

You should not withhold tax from the wages of employees who claim exemption from withholding on ***Form W–4, Employee's Withholding Allowance Certificate.*** Only employees who did not have to pay income tax last year and do not expect to pay any this year may claim exemption from withholding. Employees who claim exempt status on Form W–4 must renew their status by filing a new Form W–4 with you by February 15 of each year.

In addition to wages, other payments or benefits you give to your employees may or may not be subject to withholding, as discussed next.

Other Payments and Benefits

Supplemental unemployment benefits. If you pay supplemental unemployment benefits to a former employee, all or part of the payments may be taxable. You should withhold income tax on the taxable part of the payments if the employee is involuntarily separated and if the separation was caused directly by a reduction in force, discontinuance of a plant or operation, or other similar condition. It does not matter whether the separation is temporary or permanent.

Withholding for taxable supplemental unemployment benefits must be based on the withholding certificate that the employee gave to the employer who pays the benefits when they accrue.

Annuity or pension payments. Pension and annuity payments are generally subject to federal income tax withholding unless the recipient elects not to have tax withheld. The withholding rules apply to the ***taxable*** part of payments from an employer pension, annuity, profit-sharing, stock bonus or other deferred compensation plan. The rules also apply to payments from an individual retirement arrangement, and an annuity, endowment, or life insurance contract issued by a life insurance company. There is no withholding on any part of a distribution that it is reasonable to believe will not be includible in the recipient's gross income.

Recipients of payments described above may choose not to have withholding apply to their pensions or annuities. The election remains in effect until the recipient revokes it. The payer must notify the recipient that this election is available.

For purposes of withholding income tax on periodic payments, a pension or annuity is treated as though it were wages. The payer should receive a completed withholding allowance certificate (Form W–4P or other form provided by the payer) from the recipient of a pension or annuity. If a certificate is not furnished, the payer must withhold as if the recipient were married and claimed three withholding allowances. If the recipient already had a Form W–4P in effect for voluntary withholding, the Form W–4P can be honored under the new rules if the recipient is notified of the right to elect out of withholding and that the existing Form W–4P will be honored unless a new one is filed or the recipient elects out of withholding.

Tax is to be withheld on qualified total distributions under a schedule designed to reflect the special tax treatment accorded to lump-sum payments. Qualified total distributions generally are made within one taxable year of the recipient and include the balance to the credit of the employee under the plan. The tables in Publication 493, *Alternative Tax Withholding Methods and Tables*, will tell you the amount of income tax to withhold from qualified total distributions. Tax on other nonperiodic payments must be withheld at a flat 10% rate.

You, the employer, must furnish your employees and the Social Security Administration with Form W–2P, *Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments*, for an annuity subject to withholding. If an amount is withheld under an annuity contract during the year, all payments under that contract must be reported on Form W–2P.

Sick pay paid by third party. Employees may request that federal income tax be withheld from sick pay paid by third parties, such as insurance companies. An employee who wants income tax withheld from sick pay must file Form W–4S, *Request for Federal Income Tax Withholding from Sick Pay*, with the third-party payer. The third-party payer must report the total amount of each employee's sick pay and the income tax withheld, if any, to you, the employer, by January 15 following the year payments are withheld.

By January 31 following the year payments are made, you must give each employee who received sick pay from a third-party payer a Form W–2 that shows the following information:

1) The income tax withheld;
2) The amount of sick pay the employee must include in income; and
3) The amount that is nontaxable because the employee contributed to a fund or purchased insurance that pays accident or health benefits.

For more information about sick pay paid by third parties, see *Circular E*.

Bonuses and awards. If you pay bonuses, make taxable awards, or pay other supplemental wages to an employee, you must withhold income tax from the payment. If you add the payment on to the employee's regular wages, you may figure the income tax to be withheld as if the total of the supplemental and regular wages were a single wage payment for the regular payroll period. However, if you withhold tax on the regular wage portion at the appropriate rate and specifically indicate on your payroll records the amount of each payment, you may withhold on the supplemental portion using a flat 20% rate without regard for withholding allowances or the amount of regular wages.

If supplemental wages are paid separately, you may figure the tax to be withheld by adding the supplemental wages to the regular wages for either the current payroll period or the last preceding payroll period that is within the same calendar year. If tax already has been withheld from the regular wages, you may figure the tax to be withheld by using a flat rate of 20% without regard for withholding allowances and without reference to a regular wage payment.

You ***become liable*** for withholding of income tax, as well as for social security taxes and for paying federal unemployment tax, when you ***actually pay*** bonuses and vacation pay to your employees. This is true even though the right to these payments became vested in the employees at an earlier date and the vacation plan is unfunded.

Wages not paid in money. If in the course of your trade or business you pay your employee in some medium that is neither cash money nor a readily negotiable instrument, such as a check, you are said to pay them in kind. Payments in kind may be in the form of goods, lodging, food, clothing, or services. Generally, the fair value of such payments at the time they are made is subject to income tax withholding.

Meals and lodging. The value of meals is not subject to income tax withholding if the meals are furnished for the employer's convenience and on the employer's premises. The value of lodging is not subject to withholding if the lodging is furnished for the employer's convenience, on the employer's premises, and as a condition of employment.

Day-care services. The value of child and disabled dependent care services provided under an employer's written nondiscriminatory plan generally is not includible in an employee's gross income. If at the time the services are furnished, it is reasonable to believe that the employee will be able to exclude its value from gross income, you will not have to withhold income tax on it. It is also not subject to social security and federal unemployment taxes.

Educational assistance programs. If you pay for the tuition, fees, course supplies, and similar items for your employees under a qualified educational assistance program, the amounts paid in a year, up to a $5,000 maximum for each employee, are not includible in the gross income of your employees and are not subject to social security taxes, federal unemployment tax, or income tax withholding. This special tax treatment is retroactive to the beginning of 1984 and expires at the end of 1985.

Commuter transportation. If you provide qualified transportation in a commuter highway vehicle, such as a van or bus, for your employees, the value of the transportation is not includible in the income of the employees and is not subject to social security taxes, federal unemployment tax, or income tax withholding.

Withholding for idle time. Payments made under a voluntary guarantee to employees for ***idle time*** are wages for the purposes of social security and federal unemployment taxes and withholding of income tax. However, if these payments are made to employees aged 62 or older, they are not subject to social security taxes. In addition, these payments are not subject to federal unemployment tax once the recipient has reached 65. Idle time is any period during which an employee performs no services.

Also, payments for ***lost time*** to an employee who was reinstated following a determination that he or she was dismissed without cause are subject to income tax withholding.

Reimbursement for mileage. If you reimburse your employees for business mileage at a rate above the standard mileage rate set by IRS of 21 cents a mile, you must report the total reimbursement on Form W–2 in other compensation (separate W–2 forms may be used). However, the reimbursement is not subject to social security taxes, federal unemployment tax, or income tax withholding.

Excessive termination payments (golden parachutes). A golden parachute is a contract entered into by a corporation and key personnel under which the corporation agrees to pay certain amounts to the key personnel in the event of a change in ownership or control of the corporation. Payments under golden parachute contracts, like any termination pay, are subject to social security taxes, federal unemployment tax, and income tax withholding.

Beginning with payments under contracts entered into, significantly amended, or renewed after June 14, 1984, no deduction is allowed to the corporation for "excess parachute payments" and the employee is subject to a 20% nondeductible excise tax to be withheld by the corporation on all the payments. Generally, the payment is considered excessive to the extent that it equals or exceeds three times the average compensation of the recipient over the previous 5 year period. See *Circular E* for information on reporting golden parachute payments.

Interest-free and below-market interest rate loans. Generally, the following rule applies to term loans made after June 6, 1984, and to demand loans outstanding after that date if not repaid before September 18, 1984. Effective June 7, 1984, under section 7872 of the Internal Revenue Code, if an employer loans an employee (or an independent contractor) more than $10,000 at less than the applicable federal interest rate, the employer is deemed to have paid additional compensation to the employee equal to the difference between the applicable federal interest rate and the interest rate charged. This rule applies to any such loan, regardless of amount, if one of its principal purposes is the avoidance of federal tax.

The amount that is treated as additional compensation to the employee is also treated as a payment of imputed interest by the employee to the employer that is includible in the employer's income. Thus, it is deductible by the employee as an interest expense and by the employer as a business expense. This additional compensation to the employee is subject to social security taxes and the federal unemployment tax, but it is not subject to income tax withholding. Include it in compensation on Form W–2 (or Form 1099–MISC for an independent contractor). For more information, see section 7872 of the Code and the regulations to be issued under that section.

Cafeteria plans. Beginning in 1985, cafeteria plans must be written benefit plans under which all participants are employees, and the participants may choose from among cash (the only taxable benefit that can be offered) and statutory nontaxable benefits. The nontaxable benefits must be excludible from gross income under a specific section of the Internal Revenue Code (other than scholarship and fellowship grants under section 117, vanpooling under section 124, educational assistance programs under section 127, and employee fringe benefits under section 132). Included as a nontaxable benefit, under a special rule, is the cost of group term life insurance that is includible in income only because the insurance exceeds $50,000 of coverage or is on the life of the employee's spouse or children. Under a cafeteria plan, employer contributions are excluded from the wages of an employee to the extent that nontaxable benefits are elected by the employee. For more information, see section 125 of the Internal Revenue Code and the regulations to be issued under that section.

Employee fringe benefits. The following fringe benefits that an employer provides to an employee are excluded from the employee's gross income and are not subject to federal income tax withholding, social security taxes, and the federal unemployment tax:

1) A no-additional cost service, which is a service that is offered for sale to customers in the course of the employer's line of business in which the employee works and that the employer incurs no substantial additional cost, including lost revenue, for providing to employees. Examples: airline, bus, and train tickets and telephone services provided free or at a reduced price by an employer in the line of business in which the employee works.
2) A qualified employee discount that, for property, does not exceed the employer's gross

profit percentage and, for services, does not exceed 20% of the price at which the services are offered to customers.

3) A working condition benefit, which is a property or service that the employee could deduct as a business expense if the employee had paid for it. Examples: company car for business use and subscriptions to business magazines. Under special rules, all of the use of a demonstrator car by an auto salesperson is excluded if there are substantial restrictions on personal use. Also, parking facilities provided to the employee on or near the employer's business premises are excluded.

4) A de minimis benefit, which is a property or service that has so small a value as to make accounting for the benefit unreasonable or administratively impracticable. Examples: typing of a personal letter by a company secretary; occasional personal use of a company copying machine; monthly transit passes provided at a discount not in excess of $15; occasional parties or picnics for employees; occasional supper money and taxi fare for employees working overtime; holiday gifts with a low fair market value; occasional tickets for entertainment events; and coffee and doughnuts furnished to employees.

Also, meals at an eating facility operated by the employer for the employees' benefit on or near the employer's business premises if the income from the facility equals or exceeds the direct operating costs of the facility.

5) An on-premises gym or other athletic facility provided and operated by the employer if substantially all the use is by employees, their spouses, and their dependent children.

Note. In order to be excluded from the income of owners, officers, and highly compensated employees, all of the above items except a working condition benefit or a de minimus benefit other than eating facilities must be offered to employees on a non-discriminatory basis.

Beginning in July 1985, a qualified tuition reduction is also excluded from an employee's gross income and is not subject to employment taxes. A qualified tuition reduction is a reduction that an educational organization provides its employees for education, generally, below the graduate level. The education must be offered to employees on a non-discriminatory basis.

For more information on a qualified tuition reduction, see Publication 520, *Scholarships and Fellowships.* For more detailed information on fringe benefits, see Publication 535, *Business Expenses.*

Withholding on Taxable Noncash Fringe Benefits

Use the following guidelines for reporting and withholding on taxable noncash fringe benefits.

Choice of period for withholding, deposits, and reporting. For employment tax and withholding purposes, you may treat fringe benefits (including personal use of employer provided highway motor vehicles) as paid on a pay period, quarterly period, semi-annual period, annual period, or any other basis, provided that the benefits are treated as paid no less frequently than annually. You do not have to choose the same period for all employees. You may withhold more frequently for some employees than for others.

You may change the period as often as you wish as long as you treat all the benefits provided in a calendar year as paid no later than December 31 of the calendar year.

Also, you may treat the value of a single fringe benefit as paid on one or more dates within the same calendar year, even if the employee receives the entire benefit at one time. For example, if your employee receives a fringe benefit valued at $1,000 in one pay period during 1985, you may treat that fringe benefit as made in four payments of $250, each in a different pay period of 1985.

You do not have to notify the Internal Revenue Service of the use of the periods discussed in the above paragraphs.

Transfer of property. The above basis of reporting and withholding does not apply to a fringe benefit that is a transfer of tangible or intangible personal property of a kind normally held for investment, or a transfer of real property. For this kind of fringe benefit, you must use the actual date provided.

Withholding and Deposit. You may add the value of the fringe benefits to the regular wages for a payroll period and figure the withholding taxes on the total. Alternatively, you may withhold federal income tax on the value of the fringe benefits at the flat 20% rate presently applicable to supplemental wages.

You must withhold the applicable income, social security, and railroad retirement taxes on the date or dates you have chosen to treat the benefits as paid. The regular deposit rules, as discussed under ***Deposits***, later, apply to the withheld amounts.

Amount of deposit. For purposes of estimating the amount of income and employment taxes and depositing them timely, you may make a reasonable estimate of the value of the fringe benefits provided on the date or dates you chose to treat the benefits as paid. The estimated deposit is determined by figuring the amount you would have been required to deposit had you paid cash wages equal to the estimated value of the fringe benefits and withheld taxes from those cash wages. Even if you do not know which employee is the recipient of the fringe benefit, you should follow this procedure.

If you underestimate the value of the fringe benefits and thereby deposit less than the amount you would have been required to deposit if the applicable taxes had been withheld, you may be subject to a penalty.

If you overestimate the value of the fringe benefit and thereby overdeposit, you may either claim a refund or have the overpayment applied to the next employment tax return.

If you withhold less than the required amount of taxes from the employee, you may recover from the employee the social security, railroad retirement, or income taxes you paid on the employee's behalf. However, you must recover the income taxes before April 1 of the following year.

Election not to withhold—Special rule for highway motor vehicles. You may choose not to withhold income tax on the value of an employee's personal use of a highway motor vehicle you provided. You do not have to make this choice for all employees. You may withhold the income tax from the wages of some employees but not others. You must, however, withhold the applicable social security or railroad retirement taxes on such benefits.

You may choose not to withhold income tax by:

1) Notifying the employee in the manner described below that you choose not to withhold, and

2) Including the value of the benefits in boxes 10 and 13 on a timely furnished Form W-2.

The notice to the employee must be in writing and provided to the employee by the later of January 31 of the election year or within 30 days after a vehicle is first provided to the employee. This notice must be provided in a manner reasonably expected to come to the attention of the affected employee. For example, the notice may be mailed to the employee, included with the pay check, or posted where the employee could reasonably be expected to see it. You may also change your election not to withhold at any time by notifying the employees in the manner stated above.

Special accounting rule. Under the general income tax and reporting rule, you must determine the actual value of the fringe benefits provided in a calendar year by January 31 of the following calendar year. If the benefit is the personal use of a highway motor vehicle, you may determine the actual value for the calendar year, or determine the actual value as if the entire usage of the vehicle for the year by the employee is personal (100% income inclusion). Employees must use Form 2106 to figure business use of the vehicle if you include 100% in their income.

Instead of using the general rule, you may use the special accounting rule explained in the following paragraphs. The special accounting rule may not be used, however, for a fringe benefit that is a transfer of tangible or intangible personal property of a kind normally held for investment, or a transfer of real property.

Special accounting period. You may treat the value of the benefits provided during the last 2 months of the calendar year or any shorter period as paid in the next year. Thus, the value of benefits provided January 1, 1985, through October 31, 1985, would be treated as the value of the benefits provided in 1985. For years after 1985, the value of the benefits provided in the last 2 months of a calendar year is treated as provided in the next year together with the value of the benefits provided in the first 10 months of the next year.

Note: This does not mean that all benefits treated as paid during the last 2 months of a calendar year can be deferred until the next year. Only the value of the benefits actually provided during the last 2 months of the calendar year can be treated as paid in the next calendar year.

Conformity rules. Use of the special accounting rule is optional. You may use the rule for some fringe benefits but not others. The period of use need not be the same for each fringe benefit. However, if you use the rule for a particular fringe benefit, you must use the rule for all employees who receive that benefit.

If you use the special accounting rule, your employee must use it and must use it for the same period as you do. Your employee may not use the special accounting rule, however, unless you use it.

You do not have to notify the IRS if you use the special accounting rule. Also, you may, for appropriate reasons, change the period for which you use the rule without notifying the IRS, provided you report the income and deposit the withheld taxes, as required, for the changed period.

Amount to report on Forms 941 and W-2. The actual value of the fringe benefits provided during a calendar year (or other period, see *Special accounting rule*, earlier) must be determined by January 31 of the following year. You must report the actual value on Form W-2 and Form 941 for the 4th quarter of the prior year and pay any tax due. If you want to, you may use a separate Form W-2 for fringe benefits and any other benefit information.

Report the total value of the fringe benefits provided in the calendar year or other period in box 16 of Form W-2. Also, if you provided your

employee with the use of a highway motor vehicle and included 100% of the value of the vehicle in the employee's income, you must report it separately in box 16. If there is not enough space on the Form W–2, you must report it to the employee on a separate schedule.

If you use the special accounting rule, you must notify the affected employees of this and the period that has been used. This notice must be provided directly to the employees at or near the date Form W–2 is provided and not earlier than with the employee's last paycheck of the calendar year.

Withholding Allowances

In general, the employee's withholding allowances equal the number of exemptions that the employee will be entitled to in figuring income tax on his or her annual return. However, see *Special withholding allowance* and *Additional withholding allowances*, later.

You should ask each new employee to file a Form W–4 with you on or before his or her first day of work. This certificate is effective upon the first payment of wages and will last until the employee files a new one. The certificate must include the employee's social security number.

If an employee fails to file a Form W–4, you must withhold tax as if the employee were a single person who has claimed no withholding allowances. Married employees (and widows and widowers qualified to file their income tax returns as married persons) who have not indicated on Form W–4 that they are married will be treated as single persons for withholding purposes.

An employee who wishes to change the number of allowances claimed or to show a change in marital status should file a new Form W–4. An employee who has claimed exemption from withholding on Form W–4 and later discovers that he or she will incur income tax liability in the current tax year must give you a new Form W–4 within 10 days.

Near the end of each year, you should ask each of your employees to file a new Form W–4 for the following year if there has been a change in allowance status since the last Form W–4 was filed. If you do not receive a new Form W–4 from an employee until after December 1, see *Effective date*, later, under *Additional withholding allowances*.

An employee who holds two jobs at the same time, and claims all withholding allowances on the Form W–4 filed with one employer, must claim zero allowances on the Form W–4 filed with the second employer.

Married employees. You should inform your married employees that, if a husband and wife both work, they may divide their allowances any way they wish, but one may not claim an allowance claimed by the other.

Special withholding allowance. An employee may claim a special withholding allowance if the employee is single and works for only one employer, or is married and works for only one employer and the employee's spouse is not employed. The employee may still claim this allowance if the total wages earned on other jobs by the employee or the employee's spouse (or both) is 10% or less of the combined total wages.

Additional withholding allowances. An employee may claim additional withholding allowances on Form W–4 when the employee has a large amount of estimated deductions, losses, or credits or an estimated reduction in tax due to income averaging. For more information, see the instructions for Form W–4.

An employee who is entitled to claim additional allowances can claim them only by filing a new Form W–4 with you and completing the table on page 2 of that form which is used to figure the number of additional allowances. The additional allowances remain in effect until the employee files a new Form W–4 with you. Each employee is required to file a new form if the number of allowances the employee is entitled to claim decreases to less than the number the employee is now claiming.

Effective date. You may delay the effective date for a newly filed Form W–4 until the first status determination date (January 1, May 1, July 1, October 1) that occurs at least 30 days after you receive a new Form W–4 from your employee.

Repayment or reimbursement. If an employee gives you a new Form W–4 claiming additional withholding allowances, you may not reimburse the employee for income taxes collected during the year before the effective date of the new W–4. But you may reimburse the employee for income taxes overcollected on or after the effective date if you failed to take the new certificate into account.

Additional withholding. If an employee determines that his or her income tax liability for the year will be more than the total amount to be withheld, the employee may authorize you, if you agree, to withhold more tax than is required. The agreement must be in writing and may be in any form you want. It will be effective for any period mutually agreeable to you and your employee. Form W–4 may be used for such an agreement.

Also, a married employee may have tax withheld at the higher "single" rate by checking the appropriate box on Form W–4.

Invalid withholding certificate. Any alteration of or unauthorized addition to a withholding certificate makes it invalid. If an employee indicates to you, either orally or in writing, that the information on the withholding certificate is not valid, the certificate will be invalid even though the certificate is not yet in effect. If you realize the certificate is invalid, then you must ask your employee to furnish a new certificate. If the employee does not comply, you must withhold from the employee the same amount you would withhold from a single person claiming no exemptions. However, if a prior certificate is still in effect, you should withhold according to it.

If you have reason to believe that a withholding certificate has incorrect information, you should advise the District Director.

Filing Form W–4 with the Internal Revenue Service. You must send the Internal Revenue Service a copy of any Form W–4 received from an employee who is still employed by you at the end of the quarter if:

1) The employee filing it claims 15 or more withholding allowances; or
2) The employee filing it claims exemption from income tax withholding, but when you receive the Form W–4 you expect the employee's wages to be more than $200 a week.

Copies of the Forms W–4 that are required to be submitted because of either of the above conditions should be sent along with your quarterly employment tax returns, Forms 941 and 941E. You may send them more often if you like. But if you do, please include a cover letter giving your name, address, employer identification number, and the number of forms you are sending. If you would like to report this material on magnetic tape, you should get a copy of Revenue Procedure 84–41. It is published in Internal Revenue Cumulative Bulletin 1984–1, page 515.

Figuring Withholding

The amount to be withheld is figured on gross wages before any deductions for social security tax, pension, union dues, insurance, etc., are made. You may figure the withholding by any of several methods, the most common of which are the percentage method of withholding and the wage bracket method.

Circular E contains the applicable tables and instructions for using both of these withholding methods.

Under the percentage method, a percentage computation is made to determine the income tax that is to be withheld. This method may be used for any payroll period.

To figure the income tax to be withheld under this method:

1) Multiply the dollar amount of one withholding allowance by the number of allowances claimed on Form W–4 by the employee;
2) Subtract that amount from the employee's wages; and
3) Figure the amount to be withheld according to the employee's wage level and marital status.

The amount of one withholding allowance for payroll periods of varying lengths and the rates to apply to the taxable wages are given in *Circular E*.

You may also figure withholding using your employee's yearly wages. To do so, find in the percentage tables the income tax to be withheld from the employee's wages for the year. Then divide this amount by the number of payroll periods in the year. The result is the withholding for each payroll period.

Under the wage bracket method, you use tables, which are based on wage ranges, to compute the income tax to be withheld. These tables are reproduced in *Circular E*. Tables are for weekly, biweekly, semimonthly, monthly, and daily or miscellaneous payroll periods, for both married and unmarried employees.

To figure the income tax to be withheld under this method, determine the employee's correct payroll period, marital status, total wage payment, and the number of withholding allowances claimed on Form W–4. Then use the table for the correct payroll period and marital status, and find the amount of tax you must withhold.

Other methods. Three alternative methods that usually produce the same result are the ***quarterly average wages, annualized wages,*** and ***cumulative wages.*** Any alternative method must provide acceptable results over the full range of salary and exemption situations. You may not use a method that results in consistently deducting amounts that are less than those required under the percentage method.

Quarterly average wages method. The amount of tax to be withheld may be determined on the basis of your employee's average estimated wages for any calendar quarter. Necessary adjustments should be made during the quarter if it appears that the original estimate will be in error. The tax is withheld in equal amounts for each payroll period in the quarter. This method does not apply where only tips are included in the computation. For withholding on tips, see *Employee Tips*, later.

Annualized wages method. You may figure the amount of tax to be withheld from a wage payment to an employee by following these steps—

Step 1. Multiply the amount of the employee's wages for a payroll period by the number of payroll periods in the calendar year.

Step 2. Figure the amount of tax that you would be required to withhold for the amount computed in *Step 1* as if that amount is the actual wages for the calendar year and the employee had an annual payroll period.

Step 3. Divide the amount of tax determined by *Step 2* by the number of payroll periods in the calendar year. The result is the tax you should withhold for each payroll period.

Cumulative wages method. When an employee requests in writing that tax be withheld on the basis of cumulative wages, and when the employee has been paid since the beginning of the current calendar year on the basis of the same type of payroll period (for example, weekly or monthly), you may figure the tax to be withheld from wage payments as follows—

Step 1. Add the amount of wages to be paid the employee for the current payroll period to the total amount of wages already paid by you to the employee during the calendar year.

Step 2. Divide the total wages determined in *Step 1* by the number of payroll periods so far in the calendar year to which that amount relates, up to and including the current payroll period.

Step 3. Determine the tax that would have been withheld under the percentage method (already discussed) on the average amount of wages determined in *Step 2*, and multiply by the number of payroll periods used in *Step 2*.

Step 4. Subtract the total amount of tax already withheld from the employee's wages during the calendar year from the amount determined in *Step 3*. The excess, if any, is the amount you should withhold for the current payroll period.

Part-year employment method. If an employee works only part of a year, a request may be made to the employer to withhold income tax according to the part-year employment method. The request must be in writing and it must contain the following information:

1) The last day of employment (if any) during the calendar year with any prior employer;
2) A statement that the employee uses the calendar-year accounting period; and
3) A statement that the employee anticipates having no more than 245 days of employment either based upon all employment during the current calendar year or based upon the current term of continuous employment during the current calendar year and the following year.

A term of continuous employment starts on the first day an employee works for you and earns compensation. Continuous employment may be a single term, or two or more consecutive terms, of employment with the same employer.

A term of continuous employment ends on the earlier of: the employee's last day of work for you; or if the employee performs no services for you for more than 30 calendar days, the last work day before the period starts.

When a contract of employment (either oral or written) actually ends, the term of continuous employment is ended even if a new contract of employment is established with the same employer within 30 days.

Days of employment include all days on which an employee performs any services for an employer and days on which services are not performed because of illness or vacation, or because such days are holidays or are regular days off.

Use the following steps to figure the income tax to be withheld—

Step 1. Add the wages to be paid for the current payroll period to the wages (if any) you have already paid the employee in the current term of continuous employment.

Step 2. Divide the wages figured in *Step 1* by the total of the number of payroll periods covered by these wages plus the number of payroll periods between prior employment and current employment. The latter number is figured by dividing the number of calendar days between the employee's last day of prior employment (or the previous December 31, if later) and the first day of current employment by the number of calendar days in the current payroll period.

Step 3. Find the total tax in the withholding tax tables for the amount determined in *Step 2*. Be sure to take the employee's withholding allowances into account.

Step 4. Multiply the total number of payroll periods (number of payroll periods of unemployment plus the number of payroll periods in current term of employment) by the amount of tax determined in *Step 3*.

Step 5. Subtract the amount already withheld (if any) during the current term of continuous employment. The balance is the amount to be withheld for the current payroll period.

Any other method may be used if it produces the same result as the percentage method or the wage bracket method or a result that falls between these two methods. A result roughly within $10 of the amount that would be withheld annually under either the percentage or wage bracket method is considered the same result.

Social Security Taxes

The Federal Insurance Contributions Act (FICA) provides for a federal system of old age, survivors, disability, and hospital insurance. This system is financed through social security taxes, also known as FICA taxes. Except for income from tips, as explained later, social security taxes are levied on both you and your employees. You, as an employer, must collect and pay the employee's part of the tax. You must withhold it from wages in much the same way as income tax. Generally, meals, lodging, clothing, services, and other payments in kind are subject to social security taxes the same as wages paid in cash.

Meals and lodging, however, may not be subject to social security taxes. Meals are not taxable wages if furnished for the employer's convenience and on the employer's premises. Lodging is not taxable if furnished for the employer's convenience, on the employer's premises, and as a condition of employment. If you paid social security and federal unemployment taxes for meals and lodging you furnished to employees under these conditions, you may file a claim for a refund. The claim can cover the taxes you paid on any returns that are still open. Returns generally remain open for 3 years after they are filed, or 2 years after the tax was paid, whichever is later. See Revenue Procedure 81–69, published in Internal Revenue Cumulative Bulletin 1981–2, page 726, for information on how to file a claim.

No withholding allowances are allowed for social security taxes. A table showing the amount to be withheld from the employee's wages is in *Circular E*.

Your tax rate for 1985 is 7.05%, and your employee's tax rate is also 7.05%. For 1986, both rates increase to 7.15%.

Limit. The remuneration subject to these taxes is limited to the first $39,600 of wages you pay each employee during calendar year 1985 and $42,000 for 1986. See *Employee Tips*, later, for the treatment of combined wages and reported tips.

Successor employer. If you acquire all or substantially all of the property used in the business of another employer, or a unit of that employer's business, you may, in determining the annual limit for each of your new employees who worked for the other employer, include the wages the other employer paid to the employee.

Example. Early in 1985, you bought all the assets of a plumbing business from Mr. Martin. Mr. Brown, who had been employed by Mr. Martin and received $2,000 in wages before the date of purchase, continued to work for you. You and Mr. Brown are subject to social security taxes on only the first $37,600 ($39,600 less $2,000) of wages you pay him during the rest of the calendar year.

Employee's social security number. If one of your employees does not have a social security number and has not applied for one, you should tell the employee to submit an application on Form SS–5, *Application for a Social Security Number Card*, to the nearest office of the Social Security Administration. Form SS–5 may be obtained from the Internal Revenue Service, most U.S. Post Offices, and any Social Security office.

If any of your employees are under the age of 18, they must furnish evidence of age, identity, and U.S. citizenship along with the Form SS–5. Employees who are 18 years old or older must appear in person with this evidence at a Social Security office.

Employee taxes paid by employer. Generally, if you pay an employee's liability for social security taxes or state unemployment taxes without deduction from the employee's pay, you must include the amount of the payments in the employee's wages for purposes of social security taxes. But this rule does not apply to payments for domestic service in your home or for agricultural labor.

Federal employees. Effective January 1, 1983, federal employees became subject to the hospital insurance portion of social security taxes, and covered federal employment can be used in determining eligibility for Medicare benefits. Federal employees hired after 1983 are subject to social security taxes just like other employees. This coverage will count for figuring social security benefits of these federal employees on the same basis as other covered employment. Certain services performed by penal inmates, medical interns, and student nurses and temporary emergency employment are not covered under either of these provisions.

Sick pay. Employers and third-party payers, such as insurance companies, must withhold employee and pay employer social security taxes on most sick pay payments. In general, sick pay is any amount paid by an employer to an employee because of the employee's sickness or injury. Third-party sick pay is any amount paid by a third party to an employee that is in place of wages for any period the employee is absent due to sickness or injury. Liability for paying the employer portion of social security tax, however, will shift from the third party to the employer for whom the employee normally works if the third party promptly—

1) Withholds the employee share of social security tax,
2) Deposits such tax, and
3) Notifies the employer of the amount of the sick pay payment.

The following kinds of payments are not subject to social security taxes:

1) Payments made more than 6 months after the last calendar month in which the employee worked.
2) Payments received under a worker's compensation law.
3) Payments, or portions of payments, attributable to the employee's contribution to a sick pay plan.
4) Payments made for medical care;
5) Payments (generally for injury) that are not related to the absence from work.

6) Most payments made to a state or local government employee. The third-party payer should contact the state or local government employer for instructions.

Deferred compensation arrangements. Employer contributions to a cash or deferred compensation arrangement that is part of a qualified profit-sharing or stock bonus plan will be included in social security wages even though they may not be included in the gross incomes of the employees.

An amount deferred under a nonqualified deferred compensation plan will be treated as social security wages when the services are performed or when the employee no longer has any substantial risk of forfeiting the right to the deferred compensation, whichever is later.

Tax sheltered annuities. Employer payments made by an educational institution or a tax-exempt organization to purchase a tax-sheltered annuity for an employee are included in the employee's social security wages if the payments are made because of a salary reduction agreement.

Concurrent employment by related corporations. If two or more related corporations employ the same individual at the same time and pay this individual through a common paymaster, which is one of the corporations, the corporations are considered a single employer. They have to pay, in total, no more in social security taxes than a single employer would. Each corporation, however, must pay its own part of the employment taxes and may deduct only its own part of the wages. The deductions will not be allowed unless the corporation reimburses the common paymaster for the wage and tax payments.

Paying Social Security Taxes and Withheld Income Tax

Social security taxes and withheld income tax are reported and paid together. The following sections discuss some rules that apply equally to both types of taxes.

Employee Tips

Your employees must report to you all tips they receive while on the job. Both tips that are received directly from customers and those that charge customers add to the bill and you pay over to the employee must be reported. However, no report needs to be made for any month in which the tips were less than $20. Otherwise, they should be reported every month regardless of the total amount of wages and tips the employee has received for the year. The report must be made by the 10th day of the month after the month the tips are received. Employees may report tips of less than $20, if desired.

An employee must give his or her employer a written statement showing:

1) The name, address, and social security number of the employee;
2) The name and address of the employer;
3) The calendar month or period covered by the statement; and
4) The total amount of the tips the employee received during the period covered by the statement.

Form 4070, *Employee's Report of Tips to Employer*, available from the Internal Revenue Service, may be used for reporting tips.

The so-called gratuities collected by a club or other establishment through mandatory charges added to its members' bills are *not* tips for federal employment tax purposes. The club should continue to treat these amounts as wages subject to both employer and employee taxes under social security, the employer tax under federal unemployment, and income tax withholding.

Both income tax and employee social security tax apply. You must collect employee social security tax and income tax on tips reported by an employee. You may withhold these taxes either from wages due the employee or from other funds the employee makes available. However, you do not have to pay employer taxes on tip income received by an employee unless the wages you pay are less than the federal minimum wage, as explained later. You should stop collecting ***employee*** social security tax when the employee's combined wages and reported tips total $39,600 for 1985 ($42,000 for 1986). However, you must continue to pay ***employer*** tax on an employee's wages until the wages other than tips total $39,600 for 1985 ($42,000 for 1986), unless the wages you pay are less than the federal minimum wage, as explained later.

You are not required to withhold on tips that are not reported to you.

Income tax withholding applies for the entire year, even if the social security limits have been reached.

How to figure withholding on tips. If your employees get both regular wages and tips, you may, in figuring the income tax to be withheld, either:

1) Treat the tips as part of the employee's current or preceding wage payment and use the regular graduated withholding rates; or
2) If income tax has already been withheld from the regular wage payment, determine the tax to be withheld from tips by using a flat 20% rate.

Wages less than the federal minimum wage. If you are subject to the minimum wage provisions of the Fair Labor Standards Act, and you pay wages that are less than the federal minimum (not counting tip income) to any employee who receives and reports $20 or more in tips a month, you must pay the employer's part of the social security tax on the difference between the federal minimum wage and the wages you paid. The additional tax should be figured at the 7.05% rate for 1985 (7.15% rate for 1986) and reported as an adjustment of social security taxes on Form 941. You should stop paying employer social security tax when the employee's combined wages and the difference between the federal minimum wage and the wages you paid total $39,600 for 1985 ($42,000 for 1986).

Form W-2. Employers are required to report on Form W-2 an employee's compensation, including the tips that are reported by the employee to the employer.

Pooling or splitting of tips. Employees who participate in a tip-splitting or tip-pooling arrangement must report to their employer only the tips they actually receive and keep. They may use Form 4070 or any other form that is provided by their employer.

Example. A restaurant pays its waiter $400 in charged tips. The waiter then splits the tips with the busboy, giving the busboy one-fourth. The waiter reports to the employer only the $300 he kept. The busboy reports the $100 he received from the waiter. Both the waiter and the busboy may use Form 4070 to make their reports.

For federal unemployment tax purposes, tips reported to an employer are wages up to the amount that they are taken into account by the employer in figuring the employee's compensation under the federal minimum wage law. See *Tips under Federal Unemployment Tax*, later.

Reporting requirements for large food and beverage establishments. Starting with calendar year 1983, most large food or beverage establishments must report to the Internal Revenue Service more information about their employees' tip income. However, because these reporting requirements involve no new taxes or withholding rules, they are discussed separately in a later section. For information on these rules, see *Tip Reporting and Allocation Rules*, near the back of this publication.

Liability for Tax Withheld

You are required by law to deduct and withhold income tax and social security tax from the salaries and wages of your employees. You are liable for the payment of those taxes to the federal government whether or not you collect them from your employees. If, for example, you deduct less than the correct tax from your employees' wages, you are still liable for the full amount of the correct tax.

Liability of third parties. Any lender, surety, or other third party who pays wages directly to the employees of an employer, or to the employee's agent, is responsible for any required withholding on those wages. This includes the withholding of income, social security, and railroad retirement taxes. The third party is also liable for any interest and penalties accruing on these accounts.

If a third party supplies funds to an employer so that the employer can pay the employees' wages, and if the third party knows that the employer will not pay or deposit the taxes that are required to be withheld when due, then the third party must pay the taxes that were withheld from the employee's wages and have not been paid by the employer. However, the third party does not have to pay more than 25% of the amount that is specifically supplied for paying wages. The third party supplier also must pay interest on the taxes if they are paid after the due date of the employer's return.

Third parties are liable only for payment of the employees' part of payroll taxes. They are not liable for the employer's part. The employer must file an employment tax return for wages that he or she pays or that a third party pays and must furnish statements to employees of wages paid and taxes withheld. The employer also remains liable for any withholding taxes not paid by the third party.

Bankruptcy. A trustee in bankruptcy must withhold, report, and pay income and social security taxes from the payment of priority claims for employee's wages earned prior to, but unpaid at the time of, an employer's bankruptcy.

Where and how to file. Two copies of Form 4219, *Statement of Liability of Lender, Surety, or Other Person For Withholding Taxes*, under Sec. 3505 of the IRC, must be filed by third parties who must pay employment taxes. A separate set of forms must be filed for each employer and for each calendar quarter.

Form 4219 must be filed with the Internal Revenue Service Center where the employer for whom wages were paid, or funds were supplied, files federal employment tax returns.

Each Form 4219 should be accompanied by a check or money order made out to the Internal Revenue Service. To avoid interest, full payment should be made on or before the due date of the employer's federal employment tax return.

Returns

Social security (FICA) taxes and withheld income tax are reported together on the same form:

1) If your employees are agricultural workers, use Form 943, *Employer's Annual Tax Return for Agricultural Employees.*
2) If your employees work in your home rather than in your business—for example, to do child care, housekeeping, or gardening work—use Form 942, *Employer's Quarterly Tax Return for Household Employees.*
3) If your employees are not covered by social security taxes, use Form 941E, *Quarterly Return of Withheld Federal Income Tax.*
4) Otherwise, use Form 941, *Employer's Quarterly Federal Tax Return.*

Due dates. Form 943 is an annual return and is due one month after the calendar year ends. The other forms are quarterly returns and are due one month after the end of each calendar quarter. The periods covered by these forms are the same whether you use a fiscal year or the calendar year as your tax year. The due dates are given below:

Return and Period	Due Date
Form 943: Calendar year	January 31
Forms 941, 941E, and 942:	
1st quarter:	
January–February–March	April 30
2nd quarter:	
April–May–June	July 31
3rd quarter:	
July–August–September	October 31
4th quarter:	
October–November–December	January 31

However, if you must deposit the tax (see following discussion) and you deposit it on time and in full, you are given an extra 10 days to file the return:

Return and Period	Due Dates
Form 943: Calendar year	February 10
Forms 941 and 941E:	
1st quarter:	
January–February–March	May 10
2nd quarter:	
April–May–June	August 10
3rd quarter:	
July–August–September	November 10
4th quarter:	
October–November–December	February 10

Weekends and holidays. If a due date falls on a Saturday, Sunday, or holiday, it is postponed until the next day that is not a Saturday, Sunday, or holiday.

Paying the tax. When you pay social security and withheld income taxes—whether through deposits or with your return—you should write the following information on your check or money order:

1) Your employer identification number,
2) The type of tax you are paying, and
3) The period covered by the payment.

Penalties. If you pay your taxes late, you may have to pay a penalty, as well as interest on any overdue amounts. There are also both civil and criminal penalties for intentionally not paying taxes and for intentionally filing a false tax return or filing no return at all.

Deposits

You generally will have to make deposits of social security taxes and withheld income taxes before the return is due. You must deposit both your part and your employees' part of social security taxes. Deposits are not required for taxes reported on Form 942. For Form 942, you should pay the tax when you file the return.

Figuring deposits. Each return period is divided into a number of shorter deposit periods. Whether or not you must make a deposit for a particular deposit period depends on the amount of tax you owe at the end of the period. If the amount you owe has reached a threshold level, a deposit is required.

If the amount you owe has not reached the threshold level by the end of a deposit period, it is carried over and added to the tax for the next deposit period. If the total tax at the end of that period still is not at the threshold, it will all be carried over again to the next deposit period—and so on until either a deposit requirement is triggered or the return period ends. Once a deposit requirement is triggered, that amount is not considered when figuring whether any future deposits are required.

Deposits are figured separately for each return period—a calendar quarter for Forms 941 and 941E and a calendar year for Form 943. Do not add the tax owed for one return period to the tax owed for another return period when figuring deposits.

Deposit rules. Each month of the return period is divided into eight deposit periods. These periods end on the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th, and last day of every month. At the end of a deposit period, a deposit will be required if the social security and withheld income tax you owe—the amount that has not yet triggered another deposit requirement—reaches a threshold level:

1) ***$3,000 rule.*** If the tax you owe is $3,000 or more at the end of any of the eight deposit periods during the month, you must deposit at least 95% of what you owe within three banking days. You must then make up the difference in another deposit later. If the deposit is triggered during the last month of the return period, make up the difference no later than the end of the next month, as required by rule (3) below. If the deposit is triggered during any other month of the return period, make up the difference no later than the first deposit that is required after the 15th of the next month.
2) ***$500 rule.*** If the tax you owe is $500 or more at the end of the month, you must deposit all of it by the 15th of the next month. If your tax is less than $500, you may carry it over to the next month. The $500 rule does not apply if the $3,000 rule applies during the same month.
3) ***End-of-return-period rule.*** If, at the end of the return period, you have undeposited taxes that do not come under the other rules, deposit them by the end of the next month. Include any underpayments yet to be deposited under the $3,000 rule. If the total is less than $500, you can either deposit them or pay them with your return.

Example. In 1985 Jim Black's first deposit is for the period ending January 31. On that date he owes a total of $2,900 in social security and withheld income taxes. Because he is not required to make a deposit for any other period in January, this amount triggers a deposit under the $500 rule. Jim plans to mail in his deposit around February 10, in time to arrive before the February 15 due date.

For the next deposit period, the one ending February 3, Jim's social security and withheld income tax liability for the year so far stands at $3,250. But $2,900 of this amount has already triggered a deposit requirement. Jim therefore excludes it when figuring whether a deposit is required. Because the remaining $350 is not enough to itself trigger a deposit, Jim carries it over to the next deposit period.

If Jim had been required to make a deposit for an earlier period in January, the $2,900 he owes at the end of the month would not trigger a deposit. The $3,250 owed on February 3 would then trigger a 3-day deposit under the $3,000 rule.

Exception to $3,000 rule. If the tax you owe triggers the $3,000 rule, you can make the deposit by the 15th day of the next month, instead of within 3 banking days, provided:

1) It is the first time you were required to make a deposit under the $3,000 rule within the previous 4 calendar quarters and earlier months of the current calendar quarter, and
2) The deposit is less than $10,000.

How to make deposits. Make your deposit by sending a single check or postal money order covering both taxes to an authorized financial institution or a Federal Reserve bank. You can get the names of authorized institutions from a Federal Reserve bank. To be on time, deposits that are mailed must arrive at the depository by the due date. Each deposit must be accompanied by a federal tax deposit (FTD) coupon.

Form 8109, *Federal Tax Deposit Coupon Book,* will automatically be sent to you after you apply for an employer identification number. If you do not receive a book of coupons, contact your local Internal Revenue Service office. If you need more coupons, you should order them using the reorder form, Form 8109A, in the front of the coupon book. Be sure to show your name, employer identification number, and address on the reorder form. In the event you have a deposit due and there is not enough time to obtain a coupon book, blank forms (Form 8109–B) are available at local IRS offices.

If you have not received your employer identification number and must make a deposit, mail your payment with an explanation to the IRS service center where you file your return. Make your check payable to IRS and show on it your name, address, kind of tax, and period covered.

Timeliness of deposits. The timeliness of a deposit depends on the date the authorized financial institution or Federal Reserve bank receives it. A deposit received after the due date will be considered timely if you can establish that it was mailed at least two days before the due date. However, after July 1984, deposits of $20,000 or more by an employer required to deposit tax more than once a month must be received by the due date to be timely.

Penalties. If you fail to deposit social security and withheld income taxes on time with an authorized financial institution or a Federal Reserve bank, or if you overstate your deposits, you may have to pay a penalty. In addition, the Internal Revenue Service can require you to file monthly returns for these taxes (Form 941M). You should also be aware that an officer or employee of a corporation can be held personally responsible for social security and income taxes the corporation withholds from the wages of its employees.

Receipts for Employees

You must furnish copies of *Form W–2, Wage and Tax Statement,* to each employee from whom income tax or social security tax has been withheld. You must also furnish it to employees from whom income tax would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W–4. The Form W–2 must show the total wages and other compensation paid (whether or not subject to withholding), total wages subject to social security taxes, the amounts deducted for income tax and social security taxes, including the hospital insurance portion, and

the total amount of advance earned income credit payments. Fill in all the information required on the statement. More detailed information for preparing the Form W-2 is contained in Circular E.

Form W-2 (6-part) is a combined federal-state form that was designed for use by employers in states where both federal and state taxes must be withheld. This form may also be used where city or other subdivision taxes are withheld. It is printed in sets of six copies so that copies are available for filing and for the employee's records.

Furnish the receipts (copies) to employees as soon after December 31 as possible, so they may file their income tax returns early. In any event, you ***must*** furnish the employee the Form W-2 or its equivalent not later than January 31. However, if an employee who leaves your employment gives you a written request for the form earlier, you must give it to him or her within 30 days after you receive the request if the 30-day period ends before January 31. You should keep any undeliverable employee copies (copies B and C) of Form W-2 as a part of your records for a period of 4 years.

Form W-2P. This form must be used (if income tax was withheld) to report periodic retirement plan distributions—for example, retired or retainer pay, annuities, or pensions—as well as annuities paid under commercial, individually purchased contracts.

Form W-3, *Transmittal of Income and Tax Statements.* Employers must file this form annually on or before the last day of February to transmit Copy A of Forms W-2 and W-2P to the Social Security Administration in accordance with the instructions for Form W-3. These forms will be processed by the Social Security Administration, which will then furnish the Internal Revenue Service with the income tax data that it needs from these forms.

Forms W-2, W-2P, and W-3 are available on request from the Internal Revenue Service.

Correcting Forms W-2, W-2P, and W-3. If there is an error on Form W-2, W-2P, or W-3 you filed for a tax year after 1977, file Form W-2c, *Statement of Corrected Income and Tax Amounts,* and Form W-3c, *Transmittal of Corrected Income and Tax Statements,* to correct the error.

Note: Employers in Puerto Rico must file Form W-3PR and Form 499R-2/W-2PR (original copy) with the Social Security Administration. See Publication 179, Circular PR, *Guía Contributiva Federal Para Patronos Puertorriqueños.* Employers in the Virgin Islands and Guam must file Copy A of Forms W-2VI or W-2GU and W-3SS with the Social Security Administration. Employers in American Samoa must file Copy A of Form W-2AS with Form W-3SS as well as Copy 1 of Form W-2AS with W-3SS with the American Samoa Tax Office in Pago Pago. See Publication 80, Circular SS, *Federal Tax Guide for Employers in the Virgin Islands, Guam, and American Samoa.*

Federal Unemployment Tax

The federal unemployment tax system, together with the state systems, provides for payments of unemployment compensation to workers who have lost their jobs. Most employers pay both a state and federal unemployment tax. However, even if you are exempt from state tax, you may still have to pay the federal tax.

Use the following three tests to determine whether you must pay federal unemployment (FUTA) tax. Each test applies to a different category of employee, and each is independent of the others. It is possible to be liable for the tax in one category, but not in another. If a test describes your situation either during the current calendar year or during the preceding calendar year, you are subject to federal unemployment tax on the wages you pay to employees in that category during the current calendar year.

1) In general. You are subject to federal unemployment tax on the wages you pay employees who are not farmworkers or household workers if:
   a) In any calendar quarter, the wages you paid to employees in this category totaled $1,500 or more, or
   b) In each of 20 different calendar weeks, there was at least a part of a day in which you had an employee in this category. The 20 weeks do not have to be consecutive, and it does not have to be the same employee each week. Individuals on sick leave or vacations are counted as employees.

   You will also be subject to federal unemployment tax on the wages you pay to employees who are neither farmworkers nor household workers if you have to pay the tax for your farmworker employees under test (3) below.
2) Household workers. You are subject to federal unemployment tax on the cash wages you pay to household workers if the wages you paid to employees in this category totaled $1,000 or more in any calendar quarter. A household worker is an employee who performs domestic services in a private home, a college club, or a local chapter of a fraternity or sorority.
3) Farmworkers. You are subject to federal unemployment tax on the wages you pay to farmworkers if:
   a) In any calendar quarter, the cash wages you paid for the farm labor totaled $20,000 or more, or
   b) In each of 20 different calendar weeks, there was at least one day in which you had 10 or more farmworker employees. The 20 weeks do not have to be consecutive, it does not have to be the same 10 employees each week, and all 10 employees do not have to work a full day or the same part of the day. Individuals on sick leave or vacation are counted as employees.

Tips

For federal unemployment tax purposes, tips reported to an employer are wages up to the amount that they are taken into account by the employer in figuring the employee's compensation under the federal minimum wage law. Generally, beginning in 1986, all tip income (including credit card tips) reported by the employee to the employer for social security tax purposes is considered wages for federal unemployment tax purposes. However, the effective date is January 1, 1987, for any state with a legislature that did not meet in a regular session after July 18, 1984, or did not meet in a session that began before July 18, 1984, and remained in session for at least 25 calendar days after that date.

Wages not paid in money. If you pay your employees in some medium that is neither cash nor a readily negotiable instrument (such as a check), you are said to pay them "in kind." Payments in kind may be in the form of goods, lodging, food, clothing, or services. Generally, wages paid in kind are treated the same as wages paid in money. The value of a wage payment in kind is the fair market price it would have on the day it is made. For the treatment of ***meals and lodging,*** see the discussion under *Social Security Taxes.*

Payments in kind for farm labor are not considered wages. Do not count them either to figure whether you are subject to federal unemployment tax under test (3) above or to figure how much tax you owe. You should also not count payments in kind to household workers in your private home when figuring whether you are subject to federal unemployment tax under test (2) above. However, you should count them when figuring how much tax you owe on the wages of household workers in a local college club or local chapter of a college fraternity or sorority.

Employee taxes paid by employer. Generally, if you pay an employee's liability for social security taxes or state unemployment taxes (without deduction from the employee's pay), you must include the amount of the payments in the employee's wages for purposes of the federal unemployment tax. But this rule does not apply to payments for domestic service in your home or for agricultural labor.

Foreign workers. The federal unemployment tax does not apply to the wages of a worker who was admitted to the United States to perform farm labor for you before 1986 under a contract and who returns to his or her own country when the contract is completed. However, the wages you pay to an alien worker are counted in figuring whether you are subject to federal unemployment tax for your other farmworkers under rule (3) above.

Crew leader. To obtain farm labor, some farmers use the services of, or employ, individuals called "crew leaders." A crew leader is defined as anyone who:

1) Furnishes workers to perform farm labor;
2) Pays the workers (either on his or her own behalf or on behalf of the farmer) for the work they do; and
3) Has not entered into a written agreement with the farmer under which he or she is designated as an employee of the farmer.

Depending on the circumstances, workers furnished by a crew leader may be considered employees of the crew leader or employees of the farmer for purposes of the federal unemployment tax.

The crew leader is considered the employer of the workers if:

1) The crew leader is registered under the Farm Labor Contractor Registration Act, or
2) Substantially all members of the crew operate or maintain mechanized equipment as part of the service to the farmer.

The farmer is considered the employer of the workers in all other situations. In addition, the farmer is considered the employer of workers furnished by a registered crew leader if the workers are the employees of the farmer under the common-law test. For example, some farmers employ crew leaders to recruit farm workers exclusively for them. Although these crew leaders may be required to register under the Farm Labor Contractor Registration Act, the workers are hired directly by the farmer. The farmer is considered to be the employer in these cases.

Payments to survivor or estate. Payments made by an employer to a survivor or the estate of a former employee after the calendar year in which the employee died are not subject to federal unemployment tax.

Other exceptions. Not all payments that you make to your employees are considered wages for purposes of the federal unemployment tax.

For example, payments made under the worker's compensation law are not counted as wages.

In addition, the tax does not apply to certain types of employment. For example, if you hire cooperative education students, you are not subject to the federal unemployment tax on their wages.

Additional information. See *Circular E* (*Circular A* for farm labor) for a list of payments that are excluded from federal unemployment wages and a list of the types of employment that are not subject to the tax.

Figuring the Tax

The federal unemployment tax is figured on the first $7,000 in wages paid to each employee during 1985. The tax is imposed on you as the employer. You must not collect it or deduct it from the wages of your employees.

Tax rate and credit. The federal unemployment tax rate for 1985 is 6.2%. However, you are given a credit of up to 5.4% for the state unemployment tax you pay. The tax rate, therefore, can be as low as 0.8% (6.2% minus 5.4%) if your state is not subject to a credit reduction. If your state tax rate (experience rate) happens to be less than 5.4%, you are still allowed the full 5.4% credit. However, you cannot take the credit for any state taxes you fail to pay. And if for any reason you are exempt from state unemployment tax, the full 6.2% rate applies.

Example. In November 1985 you hire Alice Green and pay her $3,500 in wages before the year ends. All $3,500 is subject to the federal unemployment tax. The first $7,000 you pay her in 1986 is also subject to the tax. Alice's total wages for 1986 reach the $7,000 mark in mid-March. None of the wages you pay her in 1986 after that are subject to the tax.

Then, in July, Alice quits her job, and you hire someone to replace her. The first $7,000 you pay Alice's replacement in 1986 is also subject to the tax.

Credit reduction. The 5.4% credit for 1985 may be reduced for employers in some states. A credit reduction is required if a state's unemployment fund borrows from the federal government and keeps an outstanding balance for two or more years. For 1985, the credit was reduced for some states. These states, and the amount of the reduction for each, are listed on the 1985 Form 940, *Employers Annual Federal Unemployment (FUTA) Tax Return.* Check the form to see whether your state is among them.

Successor employer. If you take over the business of an employer who was subject to the federal unemployment tax, you may, in figuring the $7,000 limit, count the wages paid by that employer to the employees who continue to work for you.

Concurrent employment by related corporations. If two or more related corporations employ the same individual at the same time and they pay this individual through only one of the corporations (the "common paymaster"), the corporations are considered to be a single employer. They have to pay, in total, no more in federal unemployment taxes than a single employer would have to pay.

Each corporation, however, is liable for its own share of employment taxes and may deduct only its own share of the wages paid.

But to take the deduction, the corporation must reimburse the common paymaster for its share of wages and tax payments. The common paymaster cannot deduct wage and tax payments for employee services that were performed for another corporation in the related group.

Reporting and Paying the Tax

The federal unemployment tax is reported on Form 940. This form covers one calendar year and is generally due one month after the year ends. However, you may have to make deposits of the tax before filing the return.

Deposits. If at the end of any calendar quarter, you owe, but have not yet deposited, more than $100 in federal unemployment (FUTA) tax for the year, you must make a deposit by the end of the next month. The due dates are shown in the following chart:

If your undeposited FUTA tax is more than $100 on:	Deposit the full amount by:
March 31	April 30
June 30	July 31
September 30	October 31
December 31	January 31

If the tax is $100 or less at the end of a quarter, you do not have to deposit it, but you must add it to the tax for the next quarter. Then, in the next quarter, if the total undeposited tax is more than $100, a deposit will be required.

Weekends and holidays. If a due date falls on a Saturday, Sunday, or legal holiday, it is postponed until the next date that is not a Saturday, Sunday, or legal holiday.

Figuring deposits. To figure whether you must make a deposit for 1985, assume that you will be able to take the full credit of 5.4%, that is, use an effective tax rate of 0.8% (6.2% minus 5.4%). Next, figure what part of the wages you paid during the quarter is subject to the tax. Multiply that amount by 0.8%. The result is the amount of federal unemployment tax you owe for the quarter.

Fourth quarter. If the 5.4% credit for 1985 is reduced for you and other employers in your state, it creates an additional 4th quarter liability. Before the 4th quarter, you are not liable for depositing any tax owed because of a credit reduction. The credit reduction becomes final only after November 10 each year. To figure the amount of federal unemployment tax you owe for the 4th quarter, follow these steps:

1) First, using an effective tax rate of 0.8% as described above, figure the tax you owe on wages paid during the 4th quarter.
2) Next, multiply the total of the wages that were subject to federal unemployment tax in all 4 quarters by the amount of the credit reduction.
3) Add together the amounts from these two steps. The result is the federal unemployment tax you owe for the 4th quarter.

Making deposits. Deposits are made at a Federal Reserve bank or other authorized financial institution. Each deposit must be accompanied by a federal tax deposit (FTD) coupon. Form 8109, *Federal Tax Deposit Coupon Book,* will be sent to you automatically after you have applied for an employer identification number. If you do not receive a book of coupons, contact your local Internal Revenue Service office. Additional coupons may be obtained by using the reorder form, Form 8109A, in the front of the coupon book. In the event you have a deposit due and there is not enough time to obtain a coupon book, blank forms (Form 8109-B) are available at local IRS offices.

If you have not received your employer identification number and must make a deposit, mail your payment with an explanation to the IRS service center where you file your return. Make your check payable to IRS and show on it your name, address, and period covered.

Filing the return. The federal unemployment tax is reported on Form 940. You must file Form 940 on a calendar-year basis, even if you use a fiscal year as your tax year. The return is due one month after the end of the calendar year—January 31. However, if you deposit the tax on time and in full, you have an extra 10 days to file—until February 10.

Additional information. More information about the federal unemployment tax can be found in the instructions to Form 940.

Example

Peter Cone owns a furniture business which he runs with four full-time and two part-time employees. In 1985 Peter paid two of his full-time employees $330 a week and two $300 a week. The two part-time employees worked regular hours, and each earned $160 a week. Peter did not hire anyone else during the year, and all six employees stayed with Peter until early December, when one of them quit.

It is Peter's practice to pay his employees on Monday. If Monday is a holiday, payday is Tuesday. He generally gives his employees one raise a year, beginning with the first paycheck in January.

The sections that follow discuss how Peter figured his employment taxes for the year. They show how he figured his deposits and filled out Forms 940 and 941. Only the 4th quarter Form 941 is illustrated.

Social Security and Withheld Income Tax: Form 941

Peter files Form 941 quarterly. On it he reports:

1) Income tax he withholds from his employees' wages, and
2) Social security (FICA) tax, both the part he withholds from his employees' wages and the part he pays as an employer.

Before filing Form 941, Peter must deposit these two taxes at various times during the quarter.

Each of Peter's employees has already filled out a Form W-4. Form W-4 tells Peter:

1) How many withholding allowances the employee claims, and
2) Whether to withhold at the "married" or at the "single" rate.

Using this information, Peter finds the correct amount to withhold in Publication 15, *Circular E, Employer's Tax Guide.* Peter uses the wage bracket tables in the January 1985 *Circular E* to find the correct amount to withhold during the 4th quarter. The tables are for wages paid after December 1984.

In the 4th quarter of 1985, the first payday for Peter's employees is Monday, October 7. His income tax withholding for this payday is shown in the chart below:

Employee	Wages for the week	Withholding rate and allowances	Amount to be withheld
J. Jones	$ 330	2 - married	$ 34.00
M. Smith	330	3 - married	31.00
H. White	300	4 - married	23.00
T. Brown	300	1 - single	41.00
R. Apple	160	3 - single	10.00
F. Plum	160	0 - married	14.00
Total	$1,580		$153.00

Peter's liability for withheld income tax on this payday totals $153.00. If any of his employees had asked him (on Form W-4) to withhold an extra amount, Peter would have included it with the total.

Peter also withholds 7.05% of each employee's wages as social security tax and pays a

7.05% share himself, for a total of 14.10%. Peter's liability for social security tax on this payday is $222.78 ($1,580 total wages times 14.10%).

Social security tax applies to only the first $39,600 paid to each employee in 1985 ($42,000 in 1986). If any of Peter's employees had already earned $39,600, or had reached this limit on the October 7 payday, Peter would have excluded any wages over that amount when figuring the tax. However, none of Peter's employees will earn more than the limit in 1985.

On this payday, Peter's total liability for both social security (FICA) tax and withheld income tax is $375.78 ($222.78 plus $153.00). The following chart shows Peter's tax liability for the paydays in the 4th quarter:

Payday	Total wages paid	Income tax withheld	Total FICA (14.10%)
October 7	$ 1,580	$ 153.00	$ 222.78
October 15	1,580	153.00	222.78
October 21	1,580	153.00	222.78
October 28	1,580	153.00	222.78
November 4	1,580	153.00	222.78
November 12	1,580	160.00	222.78
November 18	1,580	160.00	222.78
November 25	1,580	160.00	222.78
December 2	1,580	160.00	222.78
December 9	1,280	119.00	180.48
December 16	1,460	146.00	205.86
December 23	1,460	146.00	205.86
December 30	1,460	146.00	205.86
Total	$19,880	$1,962.00	$2,803.08

Making deposits

Peter's schedule for making deposits depends on the total amount of social security and withheld income tax he owes at the end of each of eight deposit periods within the month. The eight periods end on the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th, and last day of every month.

On the first payday of the 4th quarter, Peter's liability for social security and withheld income tax totals $375.78. Because this payday falls on October 7, he owes this amount for the October 4–7 deposit period. If he had owed $3,000 or more, he would have been required to make a deposit within 3 banking days after the period ended. That would be by October 10. But because the amount Peter owes is less than $3,000, no deposit was required on that date.

The second payday for Peter's employees during the 4th quarter fell within the October 12–15 deposit period. Peter's payroll and his liability for social security and withheld income tax were the same as for the first payday. Therefore, his liability for this deposit period totaled $751.56 ($375.78 times 2 paydays). This total was still under $3,000, so again no deposit was required.

By the end of October, Peter's liability for social security and withheld income tax had grown to $1,503.12 ($375.78 times 4 paydays). This was still not enough to trigger a 3-day deposit. But it is enough to trigger another deposit requirement. If at the end of the month, an employer owes $500 or more (but less than $3,000), a deposit is required by the 15th of the next month.

During November, Peter's payroll remained the same. But J. Jones gave Peter a new Form W-4, cutting his withholding allowances to zero. This increased his weekly income tax withholding from $34.00 to $41.00. Peter put the change into effect with Jones' November 12 paycheck. The following chart shows how the social security and withheld income tax Peter owed added up during November:

Payday	Total wages paid on the payday	Taxes owed for the payday	Taxes owed since last deposit requirement
November 4	$1,580	$375.78	$ 375.78
November 12	1,580	382.78	758.56
November 18	1,580	382.78	1,141.34
November 25	1,580	382.78	1,524.12

Since the total never reached $3,000, Peter was not required to make a deposit under the 3-day rule. However, at the end of the month, the total was enough ($500 or more) to trigger a deposit by December 15.

Note that when figuring his deposit requirements, Peter did not add any of the taxes owed for October to those he owed in November, even though he did not have to deposit the October taxes until November 15. If Peter's October taxes had not triggered a deposit requirement, he would have carried them over and added them to the taxes he owed for November. But because the October taxes were already subject to a deposit requirement, they did not have to be considered when figuring later deposits.

In December, T. Brown quit his job. He consequently received only one paycheck for the month. H. White then began working overtime, earning $360 a week for the last three paydays of the year. At the same time, F. Plum began working full-time, earning $280 a week. Because of their changes in pay, Peter had to refigure their income tax withholding. He also refigured their social security tax withholding and his own social security tax share. Peter's employment taxes in December reflected these changes in his payroll:

Payday	Total wages paid on the payday	Taxes owed for the payday	Taxes owed since last deposit requirement
December 2	$1,580	$382.78	$ 382.78
December 9	1,280	299.48	682.26
December 16	1,460	351.86	1,034.12
December 23	1,460	351.86	1,385.98
December 30	1,460	351.86	1,737.84

Again, a 3-day deposit was not required. But a deposit by January 15, 1986, was.

Filling out the return

Peter begins filling out Form 941 by using the preaddressed label with his name, address, and employer identification number. The label identifies the quarter the return is for as the one ending on December 31, 1985. Since it is a 4th quarter return, he does not have to fill in line 1. If Peter had gone out of business in 1985, he would write "Final" in the space just above line 1 on the Form 941 for the period in which he stopped paying wages.

Line 2. Peter enters the total wages he paid in the quarter, $19,880.00.

Line 3. Next, Peter enters the total amount of income tax he withheld from his employees' wages during the quarter, $1,962.00, on line 3.

Line 5. Because Peter does not have to make any adjustments to correct for errors in the withholding he reported for the first 3 quarters of the year (line 4), the amount on line 3 carries over unchanged to line 5.

Line 6. None of Peter's employees earned more than the $39,600 limit for the year, so all of what they were paid during the quarter, $19,880.00, is counted as "taxable social security wages." Peter enters 14.10% of this amount, or $2,803.08, as his social security tax on this line. This includes both his share and the amount he withheld from his employees' wages.

Lines 8 and 10. Because Peter's employees did not earn any taxable tips (line 7) and because he does not have to make any adjustments to correct for errors in social security taxes he reported for the first 3 quarters of the year (line 9), the amount on line 6 carries over unchanged to lines 8 and 10.

Line 14. Peter then adds the withheld income tax and social security tax, and enters the total $4,765.08.

Line 16. Because none of Peter's employees received advance payments of the earned income credit (line 15), the amount on line 14 carries over unchanged to line 16.

Lines 16 and 17. Peter shows that the amount of tax he owed for the quarter and the amount he deposited are the same. He therefore does not have to make a payment with his return (line 18), nor is he due a refund (line 19).

Date and signature. Because Peter deposited the tax on time and in full, he has an extra 10 days to file his return. He takes advantage of this extension and files on February 7.

Federal Unemployment Tax: Form 940

Peter must pay state as well as federal unemployment tax. Peter's state had given him an experience rating of 3.0% for 1985. Since his state bases its tax on the first $7,000 of wages paid to each employee, and since Peter paid each of his employees more than that amount in 1985, he must pay the state tax on $42,000 ($7,000 times 6 employees). Peter paid $1,260 (3.0% of $42,000) in state unemployment tax during 1985.

For federal unemployment tax, Peter must both fill out a Form 940 for the year and make any deposits that might be required. A deposit is required if an employer has more than $100 of the tax outstanding at the end of a calendar quarter.

Making deposits

The federal unemployment tax rate is 6.2%, figured on the first $7,000 in wages paid to each employee in 1985. However, Peter begins by figuring his deposits under the assumption that he will receive full credit for the state unemployment tax he paid. The maximum credit allowed is 5.4%, so Peter figures his deposits using an effective tax rate of 0.8% (6.2% minus 5.4%). Although Peter has a state experience rate of less than 5.4%, he is still able to take the 5.4% credit.

Peter will not know until the end of the year whether the 5.4% credit will be reduced for employers in his state. If it is reduced, he must take the reduction into account when figuring the deposit for the 4th quarter.

First quarter. There were 12 paydays for Peter's employees in the 1st quarter of 1985. Each employee's wages remained the same on all 12 paydays. The following chart shows how much of each employee's total wages for the 1st quarter are subject to federal unemployment (FUTA) tax:

Employee	Wages paid in 1st quarter	Wages subject to FUTA in 1st quarter
J. Jones	$ 3,960	$ 3,960
M. Smith	3,960	3,960
H. White	3,600	3,600
T. Brown	3,600	3,600
R. Apple	1,920	1,920
F. Plum	1,920	1,920
Total	$18,960	$18,960
Tax rate		x .008
Tax liability for 1st quarter		$151.68

Because Peter has not yet paid any employee more than $7,000 for the year, all of the wages paid in the 1st quarter are subject to federal unemployment tax. He figures his tax for the quarter as 0.8% of this total, or $151.68. Because this is more than $100, Peter must deposit it by the end of April.

Second quarter. There were 13 paydays for Peter's employees in the 2nd quarter of 1985, and each employee's weekly wages remained the same. The following chart shows how much of each employee's total wages for the 2nd quarter are subject to federal unemployment (FUTA) tax:

Employee	Wages paid in 2nd quarter	Wages already subject to FUTA	Wages subject to FUTA in 2nd quarter
J. Jones	$ 4,290	$ 3,960	$ 3,040
M. Smith	4,290	3,960	3,040
H. White	3,900	3,600	3,400
T. Brown	3,900	3,600	3,400
R. Apple	2,080	1,920	2,080
F. Plum	2,080	1,920	2,080
Total	$20,540	$18,960	$17,040
Tax rate			x .008
Tax liability for 2nd quarter			$136.32

Not all of the wages Peter paid during the 2nd quarter are subject to federal unemployment tax. The wages he paid to most of his employees reached the yearly $7,000 limit during the quarter. For example, all of the wages paid to J. Jones in the 1st quarter, $3,960, were subject to the tax. Therefore, only $3,040 ($7,000 minus $3,960) of Jones' 2nd quarter wages can be subject to the tax.

Peter's federal unemployment tax liability for the 2nd quarter is $136.32, figured by multiplying the total wages subject to the tax in the quarter ($17,040) by the tax rate (0.8%). He has to deposit this amount by the end of July because it is over $100.

Third quarter. The total wages paid to each of Peter's employees in the 3rd quarter, which had 14 paydays, are shown below. The following chart shows how much of their 3rd quarter wages are subject to federal unemployment (FUTA) tax:

Employee	Wages paid in 3rd quarter	Wages already subject to FUTA	Wages subject to FUTA in 3rd quarter
J. Jones	$ 4,620	$ 7,000	$ -0-
M. Smith	4,620	7,000	-0-
H. White	4,200	7,000	-0-
T. Brown	4,200	7,000	-0-
R. Apple	2,240	4,000	2,240
F. Plum	2,240	4,000	2,240
Total	$22,120	$36,000	$4,480
Tax rate			x .008
Tax liability for 3rd quarter			$35.84

Of the total wages paid during this quarter, only $4,480 is subject to the tax. This is because the wages paid to four of Peter's employees had already reached the $7,000 limit in previous quarters. Peter's tax liability for the quarter is $35.84 (0.8% of $4,480).

Peter is not required to make a deposit of his federal unemployment tax for the 3rd quarter because the amount he owes is not more than $100.

Fourth quarter. There were 13 paydays for Peter's employees in the 4th quarter. However, payroll changes in December caused the quarterly totals for some of the employees to change.

T. Brown quit his job in December and received only one paycheck in that month. H. White then started working overtime, earning $360 a week for the last three paydays. At the same time, F. Plum started working full time at $280 a week. The following chart shows each employee's total wages for the 4th quarter and how Peter figured his federal unemployment (FUTA) tax for that quarter.

Employee	Wages paid in 4th quarter	Wages already subject to FUTA	Wages subject to FUTA in 4th quarter
J. Jones	$ 4,290	$ 7,000	$ -0-
M. Smith	4,290	7,000	-0-
H. White	4,080	7,000	-0-
T. Brown	2,700	7,000	-0-
R. Apple	2,080	6,240	760
F. Plum	2,440	6,240	760
Total	$19,880	$40,480	$1,520
Tax rate			x .008
Tax liability for 4th quarter			$12.16

Only $1,520 of the 4th quarter wages paid to the last two employees listed is subject to the tax. The wages paid to the first four had reached the $7,000 limit in earlier quarters. Therefore, Peter's federal unemployment tax liability for the 4th quarter is only $12.16 (0.8% times $1,520). However, if Peter had hired someone to take T. Brown's place when he quit in December, the tax would be more because the new employee's wages would be subject to the tax.

Peter adds the $12.16 tax from the 4th quarter to the $35.84 tax from the 3rd quarter, which he was not required to deposit. Although this total, $48.00, is not enough to require a 4th quarter deposit, Peter must add to this total any tax liability that is due to a credit reduction for calendar year 1985 to figure if a deposit is required for the 4th quarter.

Peter had assumed the full credit of 5.4% when he made his deposits for the first 2 quarters. He figured his deposits under the assumption that his effective tax rate would be 0.8% (6.2% tax rate minus 5.4% credit). But when he received his 1985 Form 940 at the end of the year, he saw that the 5.4% credit had been reduced by 0.7% for employers in his state. The credit reduction means that his effective rate is 0.7% more than he had assumed. This reduction increases Peter's 1985 liability. The increase is added to his 4th quarter liability.

Peter had 6 employees during 1985, and he paid each of them at least $7,000 during the year. He must therefore figure the credit reduction on $42,000 ($7,000 times six employees). Peter's credit reduction is $294 (0.7% of $42,000). Since this is more than $100, he must deposit it and the $48.00 tax figured earlier for the 3rd and 4th quarters by the end of January 1986.

Filling out the return

Peter begins filling in Form 940 by using the preaddressed label with his name, address, and employer identification number. If he used a trade name, he would also add that if it was not already on the label.

Items A and B. Peter checks the "Yes" box for item A and enters the amount he paid to the state unemployment fund, $1,260. He then checks the "Yes" box for item B and enters the name of the state and his state reporting number.

Because Peter was able to answer "Yes" to both of these items, he will fill out Part II of the form. If he had checked a "No" box for either of them, he would have had to fill out Parts III and V instead. (Part V is on the back of the form and is not illustrated here.) All employers must fill out Part I. Before going any further with the form, Peter decides to fill in his record of tax liability in Part IV.

Tax liability record (Part IV). Peter enters his tax for the 1st quarter, $151.68, in the first column.

Peter then enters his tax for the 2nd quarter, $136.32, in the second column.

Peter next enters his 3rd quarter tax, $35.84, in the third column.

Peter's liability for the 4th quarter, $306.16, is the sum of the $12.16 he figured for the 4th quarter and the $294 due to the credit reduction. He enters $306.16 in the fourth column.

In the last column, Peter enters the total of all his deposits, $630. If he had gone out of business during 1985, he would write "Final" on the following line.

Peter is now ready to fill out the rest of the form.

Part I, line 1. Peter enters the total amount he paid to his employees during 1985. His payroll was $81,500 for the year.

Line 2. None of the wages he paid in 1985 were exempt from federal unemployment tax, so Peter enters "None" on this line. (The wages paid to a family member would be an example of wages that are exempt.)

Line 3. Peter enters $39,500, the amount of wages he paid that was over the $7,000 limit for each employee. (Any amount included on line 2 should not be included again on this line.)

Line 4. Peter enters $39,500, the sum of lines 2 and 3.

Line 5. Peter subtracts his exempt wage payments on line 4 from his total wage payments on line 1. He enters the difference, $42,000, on line 5. This is the amount of his 1985 wage payments that are subject to federal unemployment tax.

Line 6. It is here that Peter figures his credit reduction. He finds the line for his state and writes in the portion of his federal taxable wages (line 5) that also come under the unemployment tax laws of his state. Since Peter did business in only one state, and since none of the wages he paid were exempt from the unemployment tax laws of that state, he enters the full amount from line 5, $42,000. Peter then multiplies this amount by 0.7% and writes in the result, $294. This is the amount of his credit reduction.

Line 7. Peter also enters his credit reduction on this line. If he had credit reductions from more than one state, he would have added them up and entered the total here.

Part II, line 1. Peter enters 0.8% of the $42,000 in taxable wages listed on line 5 of Part I. This entry, $336, would have been his total federal unemployment tax for the year if there had been no credit reduction.

Line 2. Peter enters the credit reduction from Part I, line 7.

Line 3. Peter adds lines 1 and 2 and enters the total, $630. This is his federal unemployment tax liability for the year.

Line 4. Peter enters the total of his three federal unemployment tax deposits, $630. This amount is found in the last column of Part IV. Peter filled out Part IV before beginning Parts I and II.

Line 5. Because Peter's deposits (line 4) equal his tax liability for the year (line 3) he does not have to make any further payments or deposits. He writes "None" on this line.

Line 6. Because Peter did not overpay the tax, he leaves this line blank.

Signature and date. Peter dates the return, signs it, and enters his title as "Owner." Because he deposited the tax in full and on time, he has an extra 10 days to file his return.

Form **941**
(Rev. January 1985)
Department of the Treasury
Internal Revenue Service

Employer's Quarterly Federal Tax Return

▶ For Paperwork Reduction Act Notice, see page 2.
Please type or print

4141

OMB No. 1545-0029
Expires: 12-31-85

Your name, address, employer identification number, and calendar quarter of return. (If not correct, please change.)

31-0000000 DEC 85 D31 ▶ided

PETER CONE
362 MAIN STREET
ANYTOWN CT 06500

▶ification number

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T

If address is ▶ different from prior return, check here ☐

If you are not liable for returns in the future, write "FINAL". . . . ▶ Date final wages paid . . . ▶

Complete for First Quarter Only

1 a	Number of employees (except household) employed in the pay period that includes March 12th ▶	1a	
b	If you are a subsidiary corporation AND your parent corporation files a consolidated Form 1120, enter parent corporation employer identification number (EIN) ▶ 1b –		
2	Total wages and tips subject to withholding, plus other compensation ▶	2	19880 00
3	Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc ▶	3	1962 00
4	Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) ▶	4	
5	Adjusted total of income tax withheld	5	1962 00
6	Taxable social security wages paid $ 19,880 00 X 14.1% (.141)	6	2803 08
7 a	Taxable tips reported $ ____ X 7.05% (.0705)	7a	
b	Tips deemed to be wages (see instructions) $ ____ X 7.05% (.0705)	7b	
8	Total social security taxes (add lines 6, 7a, and 7b)	8	2803 08
9	Adjustment of social security taxes (see instructions) ▶	9	
10	Adjusted total of social security taxes	10	2803 08
11	Backup withholding ▶	11	
12	Adjustment of backup withholding tax for preceding quarters of calendar year	12	
13	Adjusted total of backup withholding	13	
14	Total taxes (add lines 5, 10, and 13) ▶	14	4765 08
15	Advance earned income credit (EIC) payments, if any (see instructions)	15	
16	Net taxes (subtract line 15 from line 14). **This must equal line IV below** (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability.)	16	4765 08
17	Total deposits for quarter, including overpayment applied from a prior quarter, from your records ▶	17	4765 08
18	Undeposited taxes due (subtract line 17 from line 16). Enter here and pay to IRS ▶	18	
19	If line 17 is more than line 16, enter overpayment here ▶ $ ____ and check if to be: ☐ Applied to next return or ☐ Refunded.		

Record of Federal Tax Liability (Complete if line 16 is $500 or more)

See the instructions under rule 4 for details before checking these boxes.

Check only if you made eighth-monthly deposits using the 95% rule ▶ ☐ Check only if you are a first time 3-banking-day depositor ▶ ☐

Date wages paid	Tax liability (Do not show Federal tax deposits here.)					
	First month of quarter		Second month of quarter		Third month of quarter	
1st through 3rd	A		I		Q	
4th through 7th	B		J		R	
8th through 11th	C		K		S	
12th through 15th	D		L		T	
16th through 19th	E		M		U	
20th through 22nd	F		N		V	
23rd through 25th	G		O		W	
26th through the last	H		P		X	
Total liability for month	I	1503.12	II	1524.12	III	1737.84
IV Total for quarter (add lines I, II, and III) ▶						4765.08

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signature ▶ Peter Cone Title ▶ Owner Date ▶ 2-7-86

Form **940**
Department of the Treasury
Internal Revenue Service

Employer's Annual Federal Unemployment (FUTA) Tax Return

▶ For Paperwork Reduction Act Notice, see page 2.

OMB No. 1545-0028

1985

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If incorrect, make any necessary change. ▶

31-0000000 DEC 85 D31

PETER CONE
362 MAIN STREET
ANYTOWN CT 06500

A Did you pay all required contributions to your state unemployment fund by the due date of Form 940? (If none required, check "No.") . . . X Yes | No

If you checked the "Yes" box, enter amount of contributions paid to your state unemployment fund . . . ▶ $ 1260 00

B Are you required to pay contributions to only one state? . . . X Yes | No

If you checked the "Yes" box, (1) Enter the name of the state where you are required to pay contributions . . . ▶ CONNECTICUT

(2) Enter your state reporting number(s) as shown on state unemployment tax return . . . ▶ 8976543 2

Part I Computation of Taxable Wages and Credit Reduction (To Be Completed by All Taxpayers)

1	Total payments (including exempt payments) during the calendar year for services of employees			1	81,500 00
2	Exempt payments. (Explain each exemption shown, attaching additional sheets if necessary) ▶	Amount paid			
		2	NONE		
3	Payments for services of more than $7,000. Enter only the excess over the first $7,000 paid to individual employees not including exempt amounts shown on line 2. Do not use the state wage limitation	3	39,500	00	
4	Total exempt payments (add lines 2 and 3)			4	39,500 00
5	**Total taxable wages** (subtract line 4 from line 1). (If any part is exempt from state contributions, see instructions) ▶			5	42,000 00

6 Credit reduction for unrepaid advances to the states listed (by 2-letter Postal Service abbreviations). Enter the wages included on line 5 above for each state and multiply by the rate shown. (See the instructions.)

(a) CT	42,000	x .007	294.00	(e) OH		x .008		Outside the United States
(b) IL		x .009		(f) PA		x .009	(i) PR	x .006
(c) LA		x .006		(g) VT		x .006	(j) VI	x .012
(d) MN		x .011		(h) WV		x .008		

7 Total credit reduction (add lines 6(a) through 6(j) and enter in Part II, line 2 or Part III, line 4) . . . ▶ 7 294 00

Part II Tax Due or Refund (Complete if You Checked the "Yes" Boxes in Both Questions A and B Above)

1	FUTA tax. Multiply the wages in Part I, line 5, by .008 and enter here	1	336 00
2	Enter amount from Part I, line 7	2	294 00
3	**Total FUTA tax** (add lines 1 and 2)	3	630 00
4	Less: Total FUTA tax deposited for the year, including any overpayment applied from a prior year (from your records)	4	630 00
5	**Balance due** (subtract line 4 from line 3—if over $100, see Part IV instructions). Pay to IRS ▶	5	NONE
6	**Overpayment** (subtract line 3 from line 4). Check if it is to be: ☐ Applied to next return, or ☐ Refunded ▶	6	

Part III Tax Due or Refund (Complete if You Checked the "No" Box in Either Question A or B Above. Also complete Part V)

1	Gross FUTA tax. Multiply the wages in Part I, line 5, by .062		1	
2	Maximum credit. Multiply the wages in Part I, line 5, by .054	2		
3	Enter the smaller of the amount in Part V, line 11, or Part III, line 2	3		
4	Enter amount from Part I, line 7		4	
5	**Credit allowable** (subtract line 4 from line 3) (If zero or less, enter 0.)		5	
6	**Total FUTA tax** (subtract line 5 from line 1)		6	
7	Less: Total FUTA tax deposited for the year, including any overpayment applied from a prior year (from your records)		7	
8	**Balance due** (subtract line 7 from line 6—if over $100, see Part IV instructions). Pay to IRS ▶		8	
9	**Overpayment** (subtract line 6 from line 7). Check if it is to be: ☐ Applied to next return, or ☐ Refunded ▶		9	

Part IV Record of Quarterly Federal Tax Liability for Unemployment Tax (Do not include state liability)

Quarter	First	Second	Third	Fourth	Total for Year
Liability for quarter	151.68	136.32	35.84	306.16	630.00

If you will not have to file returns in the future, write "Final" here (see general instruction "Who Must File") and sign the return ▶

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete, and that no part of any payment made to a state unemployment fund claimed as a credit was or is to be deducted from the payments to employees.

Signature ▶ Peter Cone Title (Owner, etc.) ▶ Owner Date ▶ 2-7-86

Form **940** (1985)

Advance Payment of Earned Income Credit

You must pay the Earned Income Credit (EIC) in advance to eligible employees who have filed a Form W-5, *Earned Income Credit Advance Payment Certificate,* with you. If an employee does not file a Form W-5, he or she cannot receive any advance payment. Any eligible employee who chooses not to get advance payment of EIC will still get full benefit of the EIC on his or her tax return.

Eligible employee. To receive advance payment of EIC, your employee must first expect to be eligible for the EIC. An employee is eligible if all the following requirements are met:

1) The employee's expected earned income and adjusted gross income must both be less than $11,000 in 1985. Do not continue advance payments to an employee once the employee's wages are $11,000 or more in 1985.
2) The employee must not have any income from abroad or from U.S. possessions that he or she can exclude when figuring taxable income.
3) The employee, if married, must file a joint return or, if not married, must file as a qualifying widow(er) or head of household.
4) The employee, if not married, must pay more than half the cost of maintaining a household in the U.S.
5) The employee must have a child living with him or her for more than half of the taxable year, except when the child is away at school or on vacation.
6) The employee, if a head of household who maintains the household for his or her married child, must claim the child as a dependent unless the rule for divorced or separated parents in item 7 applies.
7) The employee, if a divorced or separated parent who has custody of his or her child, does not have to claim the child as a dependent if the child's other parent will be able to claim the exception only because the employee releases his or her claim in writing or because the exemption is granted to the child's other parent by a pre-1985 instrument (such as a separation agreement or divorce decree). This rule about the exemption for the child also applies if the employee files a joint return with his or her present spouse.

Form W-5. The employee must file Form W-5 with you before any advance EIC payment can be made. On Form W-5, the employee certifies that he or she expects to be eligible for EIC and has no other certificate in effect with any other current employer. Once filed, it will stay in effect for one calendar year, unless it is revoked by the employee or another Form W-5 is filed to replace it. Employees must file a new Form W-5 each year.

On the Form W-5, the employee must show if his or her spouse has a Form W-5 in effect for the year with the spouse's employer. If your employee's spouse has one in effect, the maximum amount of the advance payments you can make to your employee will be reduced.

If, after giving you a signed Form W-5, the employee later becomes ineligible for the EIC or the employee's spouse files a Form W-5, the employee must either revoke the previously filed form or file a new Form W-5 within 10 days. This new Form W-5 must show that his or her spouse has a Form W-5 in effect with an employer. If your employee gives you a Form W-5 certifying that his or her spouse has a Form W-5 in effect, and later the spouse revokes his or her form, your employee may file a new Form W-5 showing the change, but he or she is not required to do so.

Effective date. The first Form W-5 filed by an employee each year becomes effective for the first payroll period ending on or after the day the form is received. If wage payments are made without regard to a payroll period, it becomes effective for the first payment on or after the day the form is filed. If a revised Form W-5 is filed for any year, it takes effect on:

1) The day the first payment of wages is made on or after the first status determination date (January 1, May 1, July 1, or October 1) that occurs at least 30 days after the form is received; or
2) If you choose, the day any wages are paid that is on or after the day the form is received.

Figuring the payment. To figure the amount of advance payment, you should take into account the wages paid, including reported tips as well as whether your married employee's spouse has a Form W-5 in effect.

Generally, wages for the advance EIC payment are the same as wages subject to income tax withholding. For employees who have claimed exemption from income tax withholding on Form W-4, the wages for advance EIC payments are those that would have been subject to income tax withholding. For domestic and agricultural employees, the wages for advance EIC payments are the same as wages subject to FICA tax.

After considering these factors, you can figure the amount of payment to include in the eligible employee's wage payments by using the tables contained in *Circular E.* The advance EIC payment does not change the amount of income tax or social security taxes that you withhold from your employee's wages. The advance EIC payment you make is treated as if you had paid the Internal Revenue Service on the day you paid that amount to your employee. The payment would normally be paid to the Internal Revenue Service through federal tax deposits or with your employment tax return. The advance EIC payment you make to your employee is not considered compensation for services and is not subject to payroll taxes.

Generally, you will make the advance EIC payment from withheld income and social security taxes (both the employee's and your share). If for any payroll period the advance EIC payments are more than the total withheld income tax and social security taxes (both the employee's and your share), you may:

1) Lower each advance EIC payment proportionately (each payment is reduced by an amount that has the same ratio to the excess as the payment has to the total of all advance EIC payments for the payroll period); or
2) Elect to make full payment of the advance EIC amount and have the full amounts treated as an advance payment of your tax liability. See *Election to treat excess amounts as advance tax payment,* later.

Example 1. You have ten employees, each of whom is entitled to an advance EIC payment of $10. The total of advance amounts that you paid to those employees for the payroll period is $100. The total of income tax withholding for the payroll period is $90. The total of employees' social security taxes for the period is $61.30, and the total of your employer's part of social security taxes for that period is also $61.30. The total of advance amounts paid to employees is treated as if you had paid the Internal Revenue Service on the day you paid the employees' wages. Therefore, the $100 you paid your employees must first come from the $90 of income tax withholding and then the remaining $10 comes from the total amount of the employee social security taxes. You remain liable for $112.60 of social security taxes, which is the remaining $51.30 of the employees' FICA and your full part of $61.30.

Example 2. If, in Example 1, the employer was an organization that was not subject to social security taxes, the advance amounts would be $10 greater than the $90 total of income tax withholding for the payroll period. If the ten employees were each to receive $10 in advance payments (a total of $100), the employer could lower the advance amount paid to each employee by one dollar. This is figured by subtracting the total income tax withholding for the period ($90) from the total advance payment that should be made ($100). The difference ($10) is then divided by the total advance payment that should be made ($100). The resulting amount (1/10) is multiplied by the payment that each employee should receive ($10) and this will produce the amount of reduction ($1) that is to be made to that employee's advance payment.

Election to treat excess amounts as advance tax payment. If the advance EIC payments you are to make are more than the total income tax withholding and social security taxes due for the period, you may elect not to lower the advance payment but to pay in full all advance EIC amounts for the payroll period. If you elect to make full payment, you must state on your employment tax return (Form 941, 941E, 942, or 943) the amount of the excess of advance amounts paid and the payroll period to which the excess relates. If this is not done, you must proportionately lower each advance EIC payment.

You are allowed to make this election for each separate payroll period. When this election is made, the excess of the advance amounts that you paid is treated as an advance payment of your employment taxes (income tax withholding and social security taxes) that are due for the period reported on the Form 941, 941E, 942, or 943 which includes the payroll period during which the excess was paid. If your remaining employment tax liability for the reporting period in which the excess payment is made is less than the excess payment, you may claim a credit or refund of the portion of the excess amount paid that is more than your remaining liability for the reporting period.

Employment tax returns. Remember, the amount of the advance EIC payment that you make to each employee does not change the amount that you must withhold from that employee's pay for income tax and employee social security taxes. Instead, the advance EIC payments you make are treated as being made from the amounts that you withheld as income tax and employee social security taxes and that you must pay as employer social security taxes. Furthermore, the advance EIC payments you made are treated as if you had paid over that amount to the Internal Revenue Service on the day you paid the wages. You will then take these payments into account when you file your employment tax return (Form 941, 941E, 942, or 943).

Forms 941, 941E, and 943. If you must file any of these employment tax forms, you must take the amount of advance EIC payments you made into account in completing the form. When you are figuring the amount of your total employment tax liability, you will use these amounts together with any actual federal tax deposits you made to lower the amount of any payment that may be due when you file the form.

The same rules that require you to show your employment tax liability for a specific time pe-

riod also apply for showing the amounts of advance payments you have made. If you have to show your employment tax liability on the form for each 8th-monthly period, you also have to show the amount of advance EIC payments for that same period. Similarly, if your employment tax liability, before subtracting any advance EIC payments, for any month is less than $3,000, you may show just the total advance EIC payments on the "total" line for that month in the *Record of Federal Tax Liability* part of the form.

Form 942. This form does not have a Record of Federal Tax Liability part. If you must file this form, you are to show the total amount of payments made on the line for advance EIC payments.

State and local government employers, who have entered into a section 218 agreement with the Secretary of Health, Education, and Welfare for social security coverage, cannot use the social security payments to make the advance EIC payments.

Employers in Guam and the U.S. Virgin Islands should consult their local tax office for information on the earned income credit. These employers cannot take advance EIC payments into account on Form 941SS.

Form W–2. You must show the total amount of advance EIC payments made during the year on the employee's Form W–2. On the 1985 Form W–2 this amount is to be shown in box 7.

Remember, the amounts shown on Form W–2 for income tax withheld and social security taxes withheld are not affected by any advance EIC payments the employee received. Also, no other entries on Form W–2 are changed because of these payments.

Tip Reporting and Allocation Rules

Starting with calendar year 1983, most large food or beverage establishments must report to the Internal Revenue Service more information about their employees' tip income. If you are subject to these reporting rules, you must provide the required information annually by filing Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips,* with the Internal Revenue Service. You must file this form with the Internal Revenue Service Center, Andover, MA 05501 by the end of February for the preceding calendar year.

The rules only impose additional reporting requirements. ***No new taxes or rules for withholding on tip income have been established.*** Therefore, all the other rules for reporting employee tips and for withholding income tax and social security taxes, discussed earlier in this publication under *Employee Tips,* continue to apply.

What you must report. If the reporting rules apply to your food or beverage operation, you must report the following information to the Internal Revenue Service for each calendar year for each of your separate food or beverage operations:

1) Your name, address, and employer identification number.
2) Your establishment's name and address.
3) The total gross receipts your operation derived from providing food and beverages.
4) The total amount of your charge receipts on which your customers charged tips.
5) The total amount of tips shown on your charge receipts.
6) The total amount of tips your employees reported to you.
7) The total amount of service charges of less than 10% you collected from your customers and paid over to your employees as wages.
8) The name and social security number of each employee you allocated tips to under these new reporting rules and the amount of tips you allocated to each one. This requirement will be satisfied by including an employee's tip allocation on the employee's Form W–2 and attaching a photocopy of it to your Form 8027.

Do not include carryout sales, state or local taxes, or sales on which there was a service charge of 10% or more in figuring items (3) and (4), above.

To whom the rules apply. The rules apply to your food or beverage operation if you provide food or beverages for consumption on your premises, tipping is customary, and you normally employed more than 10 people on a typical business day during the preceding calendar year. Food or beverage operations where tipping is not customary do not come under the rules. For example, a cafeteria or a "fast food" operation would generally not be covered because tipping is not usually customary at these kinds of eating places. Your operation is likewise not covered by the rules if you add a service charge of 10% or more to 95% or more of your food or beverage sales. The rules also do not apply to food or beverage operations located outside the United States.

If your business operates as a cafeteria for part of the day and as a full-service restaurant with tipping customary for the rest of the day, it is treated as a single operation covered by the rules if it employed more than 10 people. However, if you record gross receipts for the two kinds of operation separately, the receipts from your cafeteria-style service are not covered by the rules.

Most restaurants that provide table or counter service for seated customers and cocktail lounges with similar service are covered by the rules if they employ more than 10 people. An establishment may be part of a larger operation such as a hotel.

More than 10 employees. You are considered to have normally employed more than 10 people on a typical business day if the average number of hours worked by all of your employees in all of your food or beverage operations on a typical business day is more than 80 hours. (An individual who owns 50% or more in value of the stock of a corporation that operates a business is not considered an employee for this purpose.) To figure this average:

1) Consider the month you had the greatest and the month you had the least gross receipts during the preceding calendar year. The month you had the least gross receipts must be a month your establishment was open for business. If you have an establishment that was not open for business during the preceding year, see *New businesses,* later.
2) Include the hours worked by all of your employees at all of your food or beverage operations, not just tipped employees.
3) Treat all members of a group of businesses that are under common control as one employer.
4) You may estimate the number of hours an employee worked for a given food or beverage operation in a month if you have an employee who worked for more than one of your food or beverage operations during the month, or if an employee worked for both your food or beverage operation and your non-food or beverage operation.

Example. You had three food or beverage operations that were open for business in January (the month that your total gross receipts from the operations were the greatest) and September (the month that your total gross receipts from the operations were the least). In January, operation A was open 31 days with 2,500 hours worked, operation B was open 20 days with 1,000 hours worked, and operation C was open 24 days with 1,500 hours worked, for a total of 75 days and 5,000 hours. The average number of days your operations were open for business in January was 25 days (75 days divided by 3 operations) and the average number of employee hours worked per business day during January was 200 (5,000 hours divided by 25 days). During September the average number of employee hours worked per business day is 60. You are considered to have normally employed more than 10 employees on a typical business day because the 2-month average is greater than 80 hours (200 + 60 = 260; 260 divided by 2 = 130 hours).

Note that if the average number of employee hours worked per business day during any month is more than 160 hours, you meet the more-than-10-employees test and your food or beverage operations are covered by the new rules, regardless of what the average during any other month is.

New businesses. Your food or beverage operation is a new business if you did not operate any food or beverage operations during the preceding calendar year. You are not considered to have operated a food or beverage operation during a calendar year if each of your food or beverage operations was operated for less than one calendar month during the year. If your food or beverage operation is a new business, you must figure the average number of employee hours worked per business day over each of any 2 consecutive calendar months of the current calendar year. If there are any 2 consecutive calendar months in which the average number of hours worked per business day by all of your employees is more than 80 hours, your new business is considered to have more than 10 employees on a typical business day. To figure this average, follow the rules discussed for all other businesses under *More than 10 employees,* earlier.

Your new business must comply with the new tip reporting rules beginning with the first payroll period that begins after the first 2-month period in which the average employee hours worked per business day exceeded 80 hours.

How the rules work. The rules apply only if the total amount of tips reported to you by your employees during any allocation period is less than 8% of your establishment's total of food and beverage sales during that period, excluding carryout sales, state or local taxes, and sales on which there was a service charge of 10% or more but including the retail value of certain complimentary food and beverages. An allocation period can be your regular payroll period, the calendar year, or some reasonable division of a year, such as a calendar month or calendar quarter.

If your employees report tips totaling less than 8% of your total sales, you must allocate the excess of 8% of total sales over reported tips among your employees who receive tips directly from your customers or among all tipped employees if your agreement with your employees provides for allocating them this way. However, do not allocate any tips to an employee who reports tips at least equal to the employee's share of 8% of your establishment's total sales.

If your customers tip less than 8% on average, you or a majority of your employees may apply to have the percentage used in the allocation reduced from 8%. However, it cannot be reduced below 2%. The application should be made in writing to the District Director for the

Internal Revenue District in which your establishment is located. See Revenue Procedure 85–4, C.B–1, P 493 and Revenue Procedure 85–10, C.B–1, P 499 for guidelines in applying for the allocation reduction.

The allocated amount is for information purposes only. ***Do not withhold any taxes from the allocated amount.*** However, you must report any tips allocated to an employee on the employee's Form W–2 separately from the employee's wages and reported tips.

If an employee leaves your employment before the end of the calendar year and requests an early Form W–2, you do not have to include a tip allocation on the Form W–2. However, you may show the actual allocated amount if you know how much it is, or you may show an estimated allocation. In January of the next year, you must provide an amended Form W–2 to the employee if the earlier Form W–2 showed no allocation or if the estimated allocation shown was wrong by more than 5%.

Allocation rules. You may allocate tips under a formula agreed to by both you and your employees. If you cannot agree on a formula, you must allocate them according to Internal Revenue Service regulations. If you allocate tips according to a good-faith agreement between you and your employees or according to the regulations, you will not be liable to any employee if any amount is allocated improperly.

According to the formula in the regulations, you make tip allocations only to your directly tipped employees. A directly tipped employee is any employee who receives tips directly from customers, even if the tips are turned over to a tip pool. For example, waiters, waitresses, and bartenders are usually considered directly tipped employees. An employee who does not normally receive tips directly from customers is an indirectly tipped employee. Busboys, service bartenders, and cooks are examples of indirectly tipped employees. If an employee receives tips both directly and indirectly, such as through a tip-splitting or tip-pooling arrangement, the employee is treated as a directly tipped employee.

You may allocate tips under the regulations on the basis of each directly tipped employee's share of gross receipts or on the basis of each directly tipped employee's share of the total hours worked. The following example illustrates the allocation method provided in the regulations using gross receipts as the basis for allocations.

Example. Smith's is a large restaurant with gross receipts of $100,000 for the allocation period ending April 30. Employees reported tips totaling $6,200 for this allocation period. Directly tipped employees reported $5,700, while indirectly tipped employees reported $500.

Directly tipped employees	Gross receipts for payroll period	Tips reported
A	$ 18,000	$1,080
B	16,000	880
C	23,000	1,810
D	17,000	800
E	12,000	450
F	14,000	680
	$100,000	$5,700

Smith's figured its allocation as follows:

1) $100,000 (gross receipts) × 0.08 = $8,000

2) Tips reported by indirectly tipped employees = $500

3) $8,000 − $500 (indirect tips) = $7,500

4)

Directly tipped employees	Directly tipped share of 8% gross		Gross receipts ratio		Employee share of 8% gross
A	$7,500	×	18,000/100,000	=	$1,350
B	7,500	×	16,000/100,000	=	1,200
C	7,500	×	23,000/100,000	=	1,725
D	7,500	×	17,000/100,000	=	1,275
E	7,500	×	12,000/100,000	=	900
F	7,500	×	14,000/100,000	=	1,050
					$7,500

5)

Directly tipped employees	Employee share of 8% gross		Tips reported		Employee shortfall
A	$1,350	−	$1,080	=	$ 270
B	1,200	−	880	=	320
C	1,725	−	1,810	=	–0–
D	1,275	−	800	=	475
E	900	−	450	=	450
F	1,050	−	680	=	370
			Total shortfall		$1,885

Since employee C has no reporting shortfall, there is no allocation to C.

6) $8,000 − $6,200 (total tips reported) = $1,800 (amount allocable among employees with shortfall)

7)

Shortfall employees	Allocable amount		Shortfall ratio		Amount of allocation
A	$1,800	×	270/1885	=	$258
B	1,800	×	320/1885	=	306
D	1,800	×	475/1885	=	454
E	1,800	×	450/1885	=	430
F	1,800	×	370/1885	=	353

If Smith's wanted to allocate tips in the above example on the basis of hours worked, the computation would be the same except an "hours worked ratio" would be used in step (4) instead of the gross receipts ratio. The hours worked ratio for each employee is the number of hours the employee worked in the allocation period divided by the total number of hours worked by all directly tipped employees during the allocation period.

Note: The Internal Revenue Service may determine that a tipped employee received more tip income than reflected in the tip allocation.

Records

As an employer, you must keep all your records on employment taxes (income tax withholding, social security taxes, federal unemployment tax, and advance earned income credit EIC payments) for a minimum of 4 years after the due date of the return or after the tax is paid, whichever is later. In addition to the following items required for each specific type of employment tax, your records should also contain your employer identification number, copies of the returns you have filed, and the dates and amounts of deposits you have made.

Income tax withholding. The specific records you must keep for income tax withholding are:

1) Each employee's name, address, and social security number;
2) The total amount and date of each wage payment and the period of time the payment covers;
3) For each wage payment, the amount subject to withholding;
4) The amount of withholding tax collected on each payment and the date it was collected;
5) If the taxable amount is less than the total payment, the reason why it is;
6) Copies of any statements furnished by employees relating to nonresident alien status, residence in Puerto Rico or the Virgin Islands, or residence or physical presence in a foreign country;
7) The fair market value and date of each payment of noncash compensation made to a retail commission salesperson, if no income tax was withheld;
8) For wage continuation plans, information about the amount of each payment;
9) The withholding exemption certificates (Form W–4) filed by each employee;
10) Any agreement between you and the employee for the voluntary withholding of additional amounts of tax;
11) The dates in each calendar quarter on which the employee worked for you, but ***not*** in the course of your trade or business, and the amount paid for that nonbusiness work;
12) Copies of statements furnished by employees reporting tips received in their work, unless the information shown on the statements appears in another item on this list; and
13) Requests by employees to have the tax withheld figured on the basis of their individual cumulative wages.

An employee's earnings ledger, which you can buy at most office supply stores, normally has space for the information required in items (1) to (4).

Social security taxes. You also must maintain the following information in your records on the social security taxes of your employees:

1) The amount of each wage payment subject to social security tax;
2) The amount of social security tax collected for each payment and the date collected; and
3) If the total wage payment and the taxable amount differ, the reason why.

Federal unemployment tax. Additional information in your records required for the federal unemployment tax is:

1) The total amount paid to your employees during the calendar year;
2) The amount of compensation subject to the unemployment tax, and why it differs from the total compensation if there is a difference;
3) The amount you paid into the state unemployment fund; and
4) Any other information required to be shown on the unemployment tax return, and the amount of the tax.

Earned income credit (EIC). The following records must be kept for advance EIC payments:

1) Copies of employees' Forms W–5;
2) Amounts and dates of all wage payments and advance EIC payments; and
3) Dates of each employee's employment.

Magnetic media reports. Generally, the Social Security Administration will accept magnetic tape records of Copy A of Forms W–2 and W–2P. The reporting specifications for tape filing of Form W–2 are in Technical Information Bulletin 4a, *Magnetic Tape Reporting, Submitting Wage and Tax Data to Federal and State Agencies.* The reporting specifications for tape filing of Form W–2P are in Technical Information Bulletin 4b, *Magnetic Tape Reporting, Submitting Annuity, Pension, Retired Pay, or IRA Payment Information to the Federal Government on Magnetic Tape.* Form W–2 may also be reported using diskette and disk cartridges. The reporting specifications for diskette and disk cartridge filing of Form W–2 are in Technical Information Bulletin 4c, *Diskette and Disk Cartridge Reporting, Submitting Wage and Tax Data to the Federal Government on Diskette and Disk Cartridge.* You can obtain a copy of these bulletins from the Social Security Administration, P.O. Box 2317, Baltimore, Maryland 21203, Attn: Magnetic Media Coordinator; any Internal Revenue Service Center or District office; or any local Social Security Administration office.

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